
Medical Marijuana Regulatory System

Part I

Department of Revenue Department of Public Health and Environment

**Performance Audit
March 2013**



**OFFICE OF THE
STATE AUDITOR**

**LEGISLATIVE AUDIT COMMITTEE
2013 MEMBERS**

Representative Angela Williams
Chair

Senator Steve King
Vice-Chair

Senator Lucia Guzman
Senator Owen Hill
Representative Dan Nordberg

Representative Su Ryden
Representative Jerry Sonnenberg
Senator Lois Tochtrop

OFFICE OF THE STATE AUDITOR

Dianne E. Ray
State Auditor

Michelle Colin
Acting Deputy State Auditor

Eric Johnson
Legislative Audit Manager

Jenny Atchley
Nina Frant
Beverly Mahaso
Nathan White
Legislative Auditors

*The mission of the Office of the State Auditor
is to improve government for the people of Colorado.*



March 12, 2013

Members of the Legislative Audit Committee:

This report contains the results of a performance audit of the Colorado's medical marijuana regulatory system. The audit was conducted pursuant to Section 2-3-103, C.R.S., which authorizes the State Auditor to conduct audits of all departments, institutions, and agencies of state government. This first of two reports presents our findings, conclusions, and recommendations, and the responses of the Department of Revenue and the Department of Public Health and Environment. The second report is expected to be released later this year.



We Set the Standard for Good Government

This page intentionally left blank.

TABLE OF CONTENTS

	PAGE
Report Highlights	1
Recommendation Locator.....	3
CHAPTER 1: Overview of Colorado’s Medical Marijuana Regulatory System.....	13
History of Medical Marijuana Legislation.....	14
Patient Access to Medical Marijuana.....	16
Oversight of Medical Marijuana Businesses.....	16
Fiscal Overview.....	20
Audit Purpose, Scope and Methodology	21
CHAPTER 2: Licensing and Monitoring.....	25
Licensing.....	26
Monitoring.....	47
Disposition of Unauthorized Marijuana.....	53
Sales Tax Administration	57
CHAPTER 3: Financial and Strategic Management.....	61
Fee-Setting.....	63
Expenses	68
Strategic Planning	76
Performance Measurement	78
Reporting.....	81
CHAPTER 4: Compliance with Federal Marijuana Laws.	85
APPENDIX – SMART Government Act	A-1

This page intentionally left blank.



MEDICAL MARIJUANA REGULATORY SYSTEM, PART I

Performance Audit, March 2013 Report Highlights



Dianne E. Ray, CPA
State Auditor

Department of Revenue

PURPOSE

Assess how effectively the Medical Marijuana Enforcement Division (the Division) has licensed and regulated medical marijuana businesses.

BACKGROUND

- In 2000, Colorado voters approved Amendment 20, a constitutional amendment that legalized the medical use of marijuana for patients diagnosed with certain debilitating medical conditions.
- The Division was established in July 2010 to license and regulate businesses that grow, cultivate, and sell medical marijuana and products infused with marijuana.
- As of October 2012, the Division oversaw about 1,440 medical marijuana businesses.
- The Division's funding comes primarily from medical marijuana business application and licensing fees.
- Since the Division's inception, its funding has fluctuated significantly. From Fiscal Years 2011 through 2012, revenue declined by 56 percent from \$8.6 million to \$3.8 million, respectively. At the same time, expenditures increased by 11 percent from \$4.7 million to \$5.2 million.

OUR RECOMMENDATIONS

The Department of Revenue should ensure that the Division:

- Only licenses eligible medical marijuana business applicants and improves the timeliness of its licensing processes.
- Evaluates discontinuing its occupational licensing program.
- Improves its monitoring activities.
- Improves its processes for seizing and disposing of unauthorized marijuana from medical marijuana businesses.
- Improves its fee-setting practices.
- Improves controls over expenses and staff use of state vehicles.
- Develops a comprehensive strategic plan.

The Department agreed with all of our recommendations.

AUDIT CONCERN

The Division has not adequately defined the oversight activities it must perform or determined the resources it needs to implement the regulatory system envisioned by the General Assembly to oversee Colorado's emerging medical marijuana industry.

KEY FACTS AND FINDINGS

- The Division has taken an average of about 23 months to issue final licensing decisions on applications submitted by August 1, 2010, the effective date of a 2-year moratorium on new medical marijuana businesses. The shortest approval time was 436 days, while the longest approval time was 807 days.
- Of the original business license applications the Division received by August 1, 2010, 41 percent were still pending as of October 2012 and have not received final licensing decisions.
- For 13 (37 percent) of 35 new business application files we reviewed, we found evidence of potentially disqualifying information about the applicants. Ten licenses were issued, however four were questionable based on this evidence.
- At the time of our audit, the Division had not taken new occupational licensing appointments in the previous 6 months, which creates a burden because individuals cannot legally work at a medical marijuana business without a license.
- The envisioned "seed-to-sale" model for regulating Colorado's medical marijuana industry does not currently exist. The Division planned to develop a marijuana plant tracking system, spent about \$1.1 million in Fiscal Years 2011 and 2012, but was unable to pay the remaining \$400,000 and implement the system due to financial difficulties. The Division reports that it will implement the system by the end of Calendar Year 2013.
- The Division does not use the prescribed statutory process when taking marijuana related to disciplinary actions against medical marijuana businesses. Additionally, the Division has inadequate controls to ensure that seized marijuana is destroyed properly.
- The Division has not developed a systematic process for setting fees that correspond to its costs of providing regulatory oversight.
- The Division laid off a majority of its staff in Fiscal Year 2012 due to revenue shortfalls. Specifically, in Fiscal Years 2011 and 2012, the Division experienced 19 consecutive months of net losses, including a loss of about \$2.3 million in June 2011 because of large capital purchases, such as furniture, computer equipment, and software for a marijuana plant tracking system. Weaknesses in the Division's fee-setting, strategic planning, and expense controls contributed to its funding problems.
- The Department of Revenue did not identify all medical marijuana businesses in its sales tax system and underreported sales tax revenue generated by 56 dispensaries by about \$760,000 for Fiscal Years 2011 and 2012 combined.

For further information about this report, contact the Office of the State Auditor
303.869.2800 - www.state.co.us/auditor

This page intentionally left blank.

RECOMMENDATION LOCATOR

Rec. No.	Page No.	Recommendation Summary	Agency Addressed	Agency Response	Implementation Date
1	32	The Department of Revenue should ensure that the Medical Marijuana Enforcement Division (the Division) only licenses eligible medical marijuana business applicants by (a) including steps in the Division's application review process to confirm that the local authority has verified that the business is within an allowable distance from any school; (b) including steps in the Division's license renewal process to conduct criminal background checks of applicants, as required by statute, and to verify that the applicant has a valid local license; (c) establishing policies and procedures for determining the types of concerns raised in criminal history and financial background check investigations that are grounds for denial and for clearly documenting dispositions on background checks when concerns have been raised; (d) establishing a well-documented supervisory review process to ensure that all minimum requirements are met prior to the Division issuing the license; and (e) following up on the four cases identified during the audit in which auditors questioned whether the Division should have issued a license to the business, and determining the appropriate course of action.	Department of Revenue	<ul style="list-style-type: none"> a. Agree b. Agree c. Agree d. Agree e. Agree 	<ul style="list-style-type: none"> a. March 2014 b. March 2014 c. March 2014 d. March 2014 e. May 2013

RECOMMENDATION LOCATOR

Rec. No.	Page No.	Recommendation Summary	Agency Addressed	Agency Response	Implementation Date
2	39	The Department of Revenue should improve the timeliness of the Medical Marijuana Enforcement Division's processes for licensing medical marijuana businesses by (a) discontinuing pre-licensing on-site inspections as part of the initial licensing process and instead conducting risk-based on-site inspections as part of ongoing monitoring of licensed businesses, as discussed in Recommendation No. 4; (b) aligning license issuance with statutory requirements to only issue a state license once the local license has been issued or seeking statutory change, and clarifying in regulations, and policies and procedures as appropriate, the process for confirming and documenting local approval; and (c) developing policies and procedures around the use of application denials and withdrawals.	Department of Revenue	Agree	March 2014

RECOMMENDATION LOCATOR

Rec. No.	Page No.	Recommendation Summary	Agency Addressed	Agency Response	Implementation Date
3	46	The Department of Revenue should improve the Medical Marijuana Enforcement Division's (the Division) process for ensuring that employees of medical marijuana businesses pass fingerprint-based criminal history checks before beginning work at medical marijuana businesses by (a) evaluating discontinuation of its occupational licensing program; (b) determining how to best ensure that prospective employees have passed a fingerprint-based criminal history check prior to working in the medical marijuana industry, including defining what it means to "pass" a criminal history check, and revising regulations and seeking statutory change as necessary to reflect those practices; and (c) monitoring through audits, on-site inspections, or other means that medical marijuana businesses are complying with requirements established through part "b."	Department of Revenue	Agree	March 2014

RECOMMENDATION LOCATOR

Rec. No.	Page No.	Recommendation Summary	Agency Addressed	Agency Response	Implementation Date
4	51	The Department of Revenue should improve the effectiveness of the Medical Marijuana Enforcement Division's monitoring activities by (a) developing a comprehensive, risk-based compliance program that identifies which statutory and regulatory requirements will be tested for compliance at medical marijuana businesses; (b) providing guidance to medical marijuana businesses on the documentation required to demonstrate compliance with the key requirements identified in part "a"; (c) developing a risk-based methodology for selecting medical marijuana businesses to monitor; and (d) developing procedures for conducting the compliance reviews and/or requiring medical marijuana businesses to hire an independent firm to conduct audits of the business.	Department of Revenue	Agree	March 2014
5	55	The Department of Revenue should improve the Medical Marijuana Enforcement Division's (the Division) processes for seizing and disposing of unauthorized marijuana by (a) ensuring that Division staff takes and destroys unauthorized marijuana plants and products found at medical marijuana businesses only in connection with a disciplinary action against the business, as outlined in statute; (b) promulgating rules providing guidance to staff on how to take and destroy marijuana plants and products, and to determine whether medical marijuana businesses have unauthorized marijuana; (c) establishing an inventory control system to track marijuana from the time that it is taken until it is destroyed; and (d) strengthening the security of the facility used to store seized marijuana.	Department of Revenue	Agree	March 2014

RECOMMENDATION LOCATOR

Rec. No.	Page No.	Recommendation Summary	Agency Addressed	Agency Response	Implementation Date
6	59	The Department of Revenue should ensure that it can accurately determine the amount of sales tax revenue generated annually from medical marijuana businesses by (a) ensuring that medical marijuana businesses are properly flagged in the Gentax system for the purposes of reporting medical marijuana sales tax figures; (b) including a question on its sales tax application to identify medical marijuana businesses and then entering that information into the Gentax system up front; (c) following up on the 56 businesses that were not correctly identified in Gentax, the 16 businesses we identified with no evidence of a state sales tax license, and the 23 businesses we identified that did not file or pay sales taxes in Fiscal Year 2011 and 2012 to determine if taxes should have been paid; and (d) implementing a process to periodically review the Medical Marijuana Enforcement Division's list of medical marijuana businesses for the purposes of ensuring that all have a sales tax number, are in the Gentax system, and that businesses the Division understands to be operating are filing sales taxes.	Department of Revenue	a. Agree b. Agree c. Agree d. Agree	a. March 2014 b. June 2013 c. June 2013 d. March 2014

RECOMMENDATION LOCATOR

Rec. No.	Page No.	Recommendation Summary	Agency Addressed	Agency Response	Implementation Date
7	67	The Department of Revenue should improve the Medical Marijuana Enforcement Division's (the Division) fee-setting by (a) determining the specific licensing and monitoring activities that will be supported by each fee it charges, (b) establishing an ongoing systematic mechanism for collecting and analyzing data on the amount of time it takes to complete each of the licensing and monitoring activities identified in part "a" and on the associated costs of completing these activities, (c) using the analysis completed in part "b" as the basis for setting the Division's fees annually, and (d) establishing an annual target reserve amount for the Medical Marijuana License Cash Fund.	Department of Revenue	Agree	June 2014
8	71	The Department of Revenue should improve the Medical Marijuana Enforcement Division's (the Division) controls over its expenses by (a) conducting price comparisons and requesting a waiver to use a competitive bidding process when appropriate and warranted; (b) conducting a thorough analysis of the Division's current and future equipment needs and eliminating any excess equipment if it is cost-effective to do so and (c) ensuring that all expenses comply with State Fiscal Rules related to the reasonability, appropriateness, and approval of the expenses.	Department of Revenue	a. Agree b. Agree c. Agree	a. June 2013 b. October 2013 c. June 2013

RECOMMENDATION LOCATOR

Rec. No.	Page No.	Recommendation Summary	Agency Addressed	Agency Response	Implementation Date
9	74	The Department of Revenue should improve the Medical Marijuana Enforcement Division's (the Division) use of state vehicles by (a) evaluating the use of the current fleet to determine whether the Division can eliminate some fleet vehicles altogether and/or weight the fleet toward more economical vehicles; (b) reviewing the commuting arrangements for the three staff that currently have them and discontinuing these arrangements unless the Division can demonstrate that it is in the best interest of the State for these staff to have these arrangements; (c) determining whether the commuting arrangements have been properly classified and reported with respect to tax treatment for employees. If commuting arrangements were improperly reported as tax-exempt benefits, the information should be reported to State Fleet Management and the State's Central Payroll. The Department should ensure that either prior years' employee income reporting to the IRS is corrected or employees reimburse the Division for all taxable commuting; and (d) establishing controls to ensure that all future commuting arrangements are in the best interest of the State and are properly classified for tax purposes.	Department of Revenue	Agree	June 2013

RECOMMENDATION LOCATOR

Rec. No.	Page No.	Recommendation Summary	Agency Addressed	Agency Response	Implementation Date
10	77	The Department of Revenue should improve the effectiveness of the Medical Marijuana Enforcement Division’s oversight of medical marijuana businesses in Colorado by developing a comprehensive strategic plan which (1) identifies the licensing, monitoring, and enforcement activities required to effectively regulate these businesses and (2) determines the staffing and operational resources needed to perform these activities. The plan should consider different scenarios to account for the uncertain future of the medical marijuana industry in Colorado.	Department of Revenue	Agree	July 2013
11	80	The Department of Revenue should improve its method for assessing the Medical Marijuana Enforcement Division’s (the Division) performance by (a) aligning the performance measure with the Division’s actual practices to better capture the timeliness of the Division’s complete business application process; (b) clarifying what is meant when the Division “initiates” final agency action; and (c) making improvements to the Division’s My License Office system to ensure that key data points related to the Division’s performance measures are captured.	Department of Revenue	Agree	July 2013

RECOMMENDATION LOCATOR

Rec. No.	Page No.	Recommendation Summary	Agency Addressed	Agency Response	Implementation Date
12	82	The Department of Revenue should improve the Medical Marijuana Enforcement Division's (the Division) access to management data by (a) identifying and working to capture in the My License Office system the data points the Division needs to effectively track and manage medical marijuana applicants and licensees, (b) working with the Office of Information Technology to ensure that Division staff have the access permissions and training they need to run system reports, and (c) developing system reports to better track the status of applications and monitoring and enforcement efforts.	Department of Revenue	Agree	July 2013
13	87	The Department of Revenue and the Department of Public Health and Environment should work with the Governor's Office and the Attorney General to seek clarification from the federal government about potential risks to state employees involved with administering and regulating Colorado's medical marijuana system and should then communicate this information to their state employees working in the medical marijuana system.	Department of Revenue Department of Public Health and Environment	Agree Agree	July 2013 June 2013

This page intentionally left blank.

Overview of Colorado's Medical Marijuana Regulatory System

Chapter 1

In 2000, Colorado voters approved Amendment 20, a constitutional amendment that legalized the medical use of marijuana for patients diagnosed with certain debilitating medical conditions, including cancer, glaucoma, positive status for human immunodeficiency virus (HIV), or acquired immune deficiency syndrome (AIDS). The Colorado Constitution (art. XVIII, sec. 14) also allows for the medical use of marijuana to alleviate symptoms of chronic or debilitating diseases or medical conditions, or treatment for such conditions, including cachexia (general ill health with emaciation), severe pain, severe nausea, seizures, or persistent muscle spasms. Throughout this report, we will use the term “medical marijuana.” It is important to note, however, that we have not found information indicating that “medical” marijuana is a substantively different product than marijuana used for recreational purposes.

Although voters passed Amendment 20 in 2000, the General Assembly did not establish a regulatory framework for medical marijuana for nearly a decade. In the early 2000s, the federal government, under the Bush Administration, began conducting well-publicized drug enforcement activities, such as raids of medical marijuana businesses, which may have influenced states with laws legalizing medical marijuana use to put off administering their medical marijuana programs. The Obama Administration, however, took a different approach. In October 2009, that administration issued the “Ogden memo,” which advised federal prosecutors not to focus their federal drug enforcement resources on individuals complying with state medical marijuana laws. Following issuance of the Ogden memo, the number of storefront retail locations, called dispensaries, that sell medical marijuana increased in Colorado. Amendment 20 did not contemplate the possible existence of dispensaries but rather focused on requirements for patients to grow and cultivate medical marijuana themselves or obtain it from individuals called primary caregivers. Therefore, in response to the upsurge of dispensaries, the General Assembly passed the Colorado Medical Marijuana Code (House Bill 10-1284) in 2010. That bill established a system of statewide regulations governing the production and sale of marijuana for medical use.

Federal law does not recognize the lawful use of marijuana for any purpose. Nonetheless, 18 states and the District of Columbia have passed state laws legalizing the use of medical marijuana. We discuss issues related to the conflict between federal law and Colorado's Amendment 20 in Chapter 4.

History of Medical Marijuana Legislation

As the enabling law for Colorado's medical marijuana regulatory system, Amendment 20 established certain requirements that focused primarily on activities related to medical marijuana patients. Specifically, Amendment 20:

- Defined the debilitating medical conditions for which patients can use medical marijuana.
- Stipulated that patients can only receive a recommendation to use medical marijuana from a physician with whom they have a “bona fide relationship.”
- Outlined requirements for the issuance of medical marijuana cards, also referred to as “red cards” because of the red-colored ink that appears on the cards. Red cards serve as official state documentation that patients have been authorized to obtain, possess, and use marijuana for medical purposes.
- Required the Colorado Department of Public Health and Environment (Public Health) to establish and maintain a confidential Medical Marijuana Registry containing information related to medical marijuana patients.
- Established an affirmative defense for patients, physicians, and caregivers who are charged with violating state criminal laws related to marijuana. The Colorado Constitution [art. XVIII, sec. 14(1)(f)] defines a primary caregiver as “a person, other than the patient and the patient’s physician, who is eighteen years of age or older and has significant responsibility for managing the well-being of a patient who has a debilitating medical condition.” State regulations specify that a caregiver’s responsibilities should include assisting patients with daily living activities, such as transportation, housekeeping, or meal preparation, in addition to cultivating and providing medical marijuana.

To strengthen the legal framework for Colorado's medical marijuana regulatory system, the General Assembly enacted a series of medical marijuana-related laws starting in 2001. Two state departments—the Department of Revenue (Revenue) and Public Health—share responsibility for implementing the provisions of these laws. The most comprehensive legislation was passed during the 2010 and 2011 Legislative Sessions. The following bullets describe key aspects of the State's medical marijuana laws.

- **Colorado Medical Marijuana Code (House Bill 10-1284):** Established the State's primary framework for licensing and regulating medical

marijuana businesses. The bill addressed various programmatic aspects of administering Colorado's medical marijuana regulatory system and specified duties for Revenue and Public Health. For example, the bill established Revenue's authority to create the Medical Marijuana Enforcement Division, effective July 1, 2010, and outlined requirements for licensing medical marijuana businesses. Provisions that affected Public Health addressed requirements related to medical marijuana patients, primary caregivers, and physicians. In addition, House Bill 10-1284 placed a statewide moratorium on new medical marijuana businesses from August 1, 2010, through June 30, 2011. Medical marijuana businesses operating before July 1, 2010, were required to apply for licensure with Revenue by August 1, 2010, if they wanted to remain in operation. Prior to the end of the moratorium (i.e., by June 30, 2011), local authorities could adopt a resolution or ordinance to license, regulate, or prohibit the cultivation and sale of medical marijuana within their jurisdictions.

- **Physician-Patient Relationship (Senate Bill 10-109):** Established Public Health's oversight responsibilities related to physicians and patients participating in Colorado's medical marijuana regulatory system.
- **Medical Marijuana Businesses (House Bill 11-1043):** Extended for a second year (i.e., until June 30, 2012) the moratorium on new medical marijuana businesses, which was originally established by House Bill 10-1284. The bill specified that individuals could apply for new medical marijuana business licenses on or after July 1, 2012. In addition, the bill further defined requirements affecting medical marijuana businesses. For example, the bill specified limitations on the number of marijuana plants that businesses can grow and cultivate. In addition, the bill granted local authorities power to take disciplinary action against medical marijuana businesses. The bill also specified circumstances when patients can legally purchase medical marijuana prior to being issued their red cards.

Two bills that established key statutory requirements for Colorado's medical marijuana regulatory system—House Bill 10-1284 and Senate Bill 10-109—include provisions that require sunset reviews and, ultimately, the repeal of both laws. Specifically, House Bill 10-1284 requires a sunset review of Revenue's medical marijuana-related activities prior to the bill's repeal on July 1, 2015. Similarly, Senate Bill 10-109 requires a concurrent sunset review of Public Health's Medical Marijuana Program and the Colorado State Board of Medical Examiners. The bill also specifies that the Medical Marijuana Program at Public Health will be repealed on July 1, 2019.

In November 2012, Colorado voters passed Amendment 64, which legalized the use of recreational marijuana for adults who are at least 21 years of age. Although the scope of this audit focused on Colorado's medical marijuana regulatory

system, the findings and recommendations in this report may provide useful insight as state policy makers develop and implement laws and regulations governing the State's recreational marijuana industry.

Patient Access to Medical Marijuana

To buy, possess, and use medical marijuana in Colorado, a patient must meet certain eligibility requirements and obtain a red card from Public Health. Specifically, statute [Section 25-1.5-106(5), C.R.S.] requires a patient to obtain a recommendation for medical marijuana from a physician "in good standing" with the State and with whom the patient has a bona fide relationship. The physician must confirm that the patient suffers from one of the specific debilitating medical conditions that qualify an individual to use medical marijuana. The patient then submits the physician's recommendation for medical marijuana, along with other application materials, to Public Health. The current application fee for a red card is \$35. For eligible patients, the Colorado Constitution [art. XVIII, sec. 14(3)(c)] requires Public Health to issue a red card within 35 days of receiving the patient's application. Red cards are valid for 1 year. As of November 2012, about 107,000 patients in Colorado had valid red cards.

Patients can obtain medical marijuana by (1) growing and cultivating up to six marijuana plants for their personal medical use, (2) acquiring medical marijuana from their designated primary caregiver, or (3) purchasing medical marijuana from licensed dispensaries. The Colorado Constitution [art. XVIII, sec. 14(4)(a)] allows patients to possess up to 2 ounces of useable marijuana and up to six plants at any given time.

In the remainder of this report, we will focus on Revenue's licensing and regulation of medical marijuana businesses. In a subsequent report, we will discuss our findings and recommendations related to Public Health's role in Colorado's medical marijuana regulatory system, including activities that affect medical marijuana patients, physicians, and primary caregivers.

Oversight of Medical Marijuana Businesses

The Medical Marijuana Enforcement Division (the Division) at Revenue is responsible for regulating and licensing businesses that cultivate, manufacture, distribute, and sell medical marijuana in Colorado. Specifically, statute (Section 12-43.3-202, C.R.S.) requires the Division to:

- Grant or refuse state licenses for the cultivation, manufacture, distribution, and sale of medical marijuana.

- Suspend, fine, restrict, or revoke business licenses if medical marijuana businesses violate state law.
- Promulgate rules necessary for the proper regulation and control of the cultivation, manufacture, distribution, and sale of medical marijuana and for the enforcement of state law.

As of October 2012, the Division oversaw about 1,440 medical marijuana businesses, broken down into the following categories:

- A **dispensary** (also known as a medical marijuana center) is a retail business that sells patients medical marijuana or products infused with medical marijuana, such as edible products, ointments, pills, and tinctures. Statute [Section 12-43.3-402(3), C.R.S.] also allows dispensaries to sell up to six immature medical marijuana plants to patients with valid red cards. In addition, a dispensary can sell immature plants to a primary caregiver, another dispensary, or a medical marijuana-infused products manufacturer (described below). As of October 2012, about 530 dispensaries were operating in Colorado.
- A **grow operation** (also called an optional premises cultivation operation) is a facility that grows and cultivates medical marijuana plants. A grow operation may be physically located adjacent to the dispensary with which it is affiliated, or it can be in a different location and operate independently from the affiliated dispensary. As of October 2012, about 740 grow operations were operating in Colorado.
- A **medical marijuana-infused products manufacturer** is a business that manufactures products infused with marijuana, such as food or pills, which allow patients to consume marijuana other than by smoking it. As of October 2012, about 170 medical marijuana-infused products manufacturers were operating in Colorado.

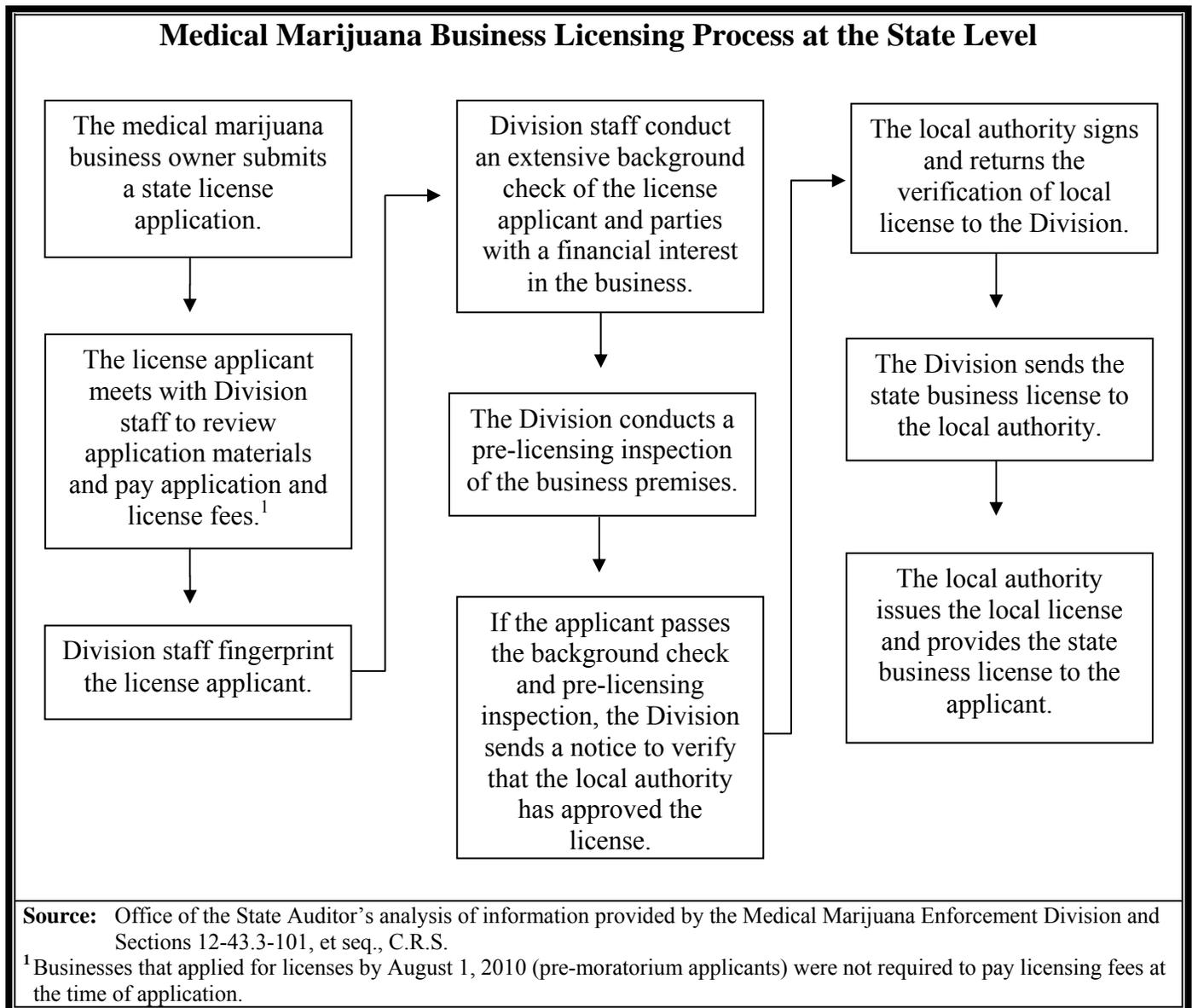
In the legislative declaration to House Bill 10-1284, the General Assembly stressed the importance of preventing individuals who do not qualify for medical marijuana from acquiring, using, or selling marijuana in violation of state law. In an attempt to reduce diversion of medical marijuana to and from the black market, the General Assembly sought to vertically integrate the medical marijuana businesses that grow and sell marijuana. Under that model, dispensaries are required to be affiliated with a specific grow operation and obtain at least 70 percent of their medical marijuana supply from that business [Section 12-43.3-103(2)(d)(I), C.R.S.]. State regulations also require patients to register with specific dispensaries so those businesses can align their medical marijuana supply with the specific amounts their patients are authorized to purchase. Similarly, infused products manufacturers are required to enter into written agreements with

a grow operation or up to five dispensaries that agree to supply medical marijuana for the manufacture of infused products [Section 12-43.3-404(3), C.R.S.].

Although the General Assembly contemplated a statewide medical marijuana industry, statute (Section 12-43.3-106, C.R.S.) allows local jurisdictions to prohibit medical marijuana businesses from operating within their borders either through a vote of the people or of the jurisdiction's governing board (e.g., city council).

Medical Marijuana Business Licensing

Medical marijuana businesses in Colorado are subject to a dual licensing process. Specifically, statute [Section 12-43.3-310(2), C.R.S.] requires businesses to first obtain a license from the local authority that governs the jurisdiction where the business is located, and then to obtain a license from the State. Statute [Section 12-43.3-302(5)(a), C.R.S.] also allows applicants to request that the Division conduct a concurrent review of the state license application at the same time that the local authority is reviewing the application. The following diagram summarizes the steps involved with the Division's licensing process. The diagram does not include information about the licensing process at the local level.



The Division issues three types of state licenses to medical marijuana businesses, as described in the following bullets.

- **Medical marijuana center licenses** are issued to dispensaries. The Division issues three categories of these licenses based on the number of patients registered with the dispensary, as described below:
 - Type 1 licenses are issued to dispensaries that serve 1-300 patients.
 - Type 2 licenses are issued to dispensaries that serve 301-500 patients.

- Type 3 licenses are issued to dispensaries that serve 501 or more patients.
- **Optional premises cultivation licenses** are issued to medical marijuana grow operations.
- **Medical marijuana-infused products manufacturing licenses** are issued to businesses that manufacture medical marijuana-infused products.

The Division also issues occupational licenses to employees of medical marijuana businesses. The Division issues the following types of occupational licenses.

- “Key” employee licenses are issued to employees who make operational or management decisions that affect the medical marijuana business, such as a controller or master grower. Key employees do not have an ownership interest in the business.
- “Support” employee licenses are issued to employees who work at a medical marijuana business but do not make operational decisions for the business, such as a sales clerk or administrative staff.
- Vendor registrations, along with the appropriate occupational licenses, are required for employees of businesses that provide services to the medical marijuana industry. For example, medical marijuana businesses may hire trim crews to harvest their crops or couriers who transport marijuana products from facility to facility. Vendors are required to obtain a key employee license for the person overseeing the vendor’s actions and support employee licenses for the staff performing the work.

According to statute [Section 12-43.3-310(6), C.R.S.], state and local medical marijuana business licenses cannot be valid for longer than 2 years. Currently, state business licenses are valid for 1 year. Therefore, medical marijuana businesses are required to renew their state licenses each year. Local authorities may establish a different renewal time frame for their licenses.

Fiscal Overview

Funding for the Division comes primarily through medical marijuana business application and licensing fees. A business pays the application and license fees when it first applies for licensure with the Division and then pays a license fee again each time that it renews its license. All revenue the Division collects is deposited into the Medical Marijuana License Cash Fund, which was established by House Bill 10-1284. Since its inception in July 2010, the Division has experienced significant fluctuations in its funding. During its first year of operation in Fiscal Year 2011, the Division collected \$8.6 million in revenue.

However, in Fiscal Year 2012 the Division's revenue declined by 56 percent to \$3.8 million. At the same time, the Division's expenses increased by 11 percent, from \$4.7 million in Fiscal Year 2011 to \$5.2 million in Fiscal Year 2012. The following table shows the Division's revenue and expenses from Fiscal Year 2011 through the first half of Fiscal Year 2013.

Medical Marijuana Enforcement Division Revenue and Expenses Fiscal Years 2011 Through 2013¹ (In Millions)			
	2011	2012	2013¹
Beginning Balance	-	\$3.9	\$2.5
Revenue	\$8.6	3.8	2.0
Expenses	4.7	5.2	0.9
Year-End Balance	3.9	2.5	TBD ¹
Source: Office of the State Auditor's analysis of data from the Colorado Financial Reporting System.			
¹ Reflects only the first 6 months of Fiscal Year 2013 (i.e., July through December 2012). The year-end balance will be determined in June 2013.			

According to the Division, several factors contributed to the \$4.8 million decrease in revenue between Fiscal Years 2011 and 2012. For example, the moratorium on new medical marijuana businesses between August 2010 and July 2012 resulted in large collections of application fees at the beginning of Fiscal Year 2011 but no application fee collections at all in Fiscal Year 2012. In addition, prior to April 2012, the Division did not collect annual licensing fees from any medical marijuana businesses that had a pending application. We discuss the Division's funding issues in more detail in Recommendation No. 7.

In Fiscal Years 2012 and 2013, the Division was appropriated \$5.7 million and 55.2 full-time equivalent (FTE) staff. However, as of February 2013, the Division employed only 15 FTE. As we discuss in more detail in Chapter 3, the Division experienced funding shortfalls that resulted in a large layoff of staff toward the end of Fiscal Year 2012. The 15 remaining FTE include management; administrative staff; and investigators who conduct pre-licensing inspections at medical marijuana businesses, process business license applications, and investigate complaints.

Audit Purpose, Scope, and Methodology

We conducted this performance audit pursuant to Section 2-3-103, C.R.S., which authorizes the State Auditor to conduct audits of all departments, institutions, and agencies of state government. Audit work was performed from August 2012 through March 2013. This report is the first of two audit reports we plan to issue

with findings and recommendations related to Colorado's medical marijuana regulatory system. The first report focuses primarily on the Division's business licensing and regulatory activities. We anticipate issuing the second report later in 2013; it will focus primarily on the Department of Public Health and Environment's role in the State's medical marijuana regulatory system. We acknowledge the cooperation and assistance provided by staff at the Division and Public Health.

For this first audit report, our primary objective was to assess how effectively the Division has licensed and regulated medical marijuana businesses. Specifically, we evaluated:

- The efficiency of the Division's business licensing process and whether the Division licenses only eligible individuals and medical marijuana businesses.
- The adequacy of the Division's enforcement activities to help ensure that medical marijuana does not enter the black market and vice versa.
- The Division's fee-setting and financial management practices.
- The adequacy of Revenue's processes for ensuring that medical marijuana businesses pay sales tax.
- The security and integrity of medical marijuana business licensing data contained in the Division's My License Office system.

We assessed the effectiveness of those internal controls that are significant to the audit objectives described above. Our conclusions on the effectiveness of those controls are described in the audit findings and recommendations. We noted certain other matters that we reported to Revenue and Division management in a separate letter dated March 5, 2013.

To accomplish our audit objectives, we:

- Reviewed relevant federal and state laws, rules, regulations, policies, and procedures related to the Division's business licensing and regulatory activities.
- Interviewed management and staff at the Division and reviewed documentation to determine the Division's processes for licensing and regulating medical marijuana businesses. We also observed Division staff conducting business inspection activities.

- Interviewed staff at Revenue and reviewed documentation to determine the State's processes for collecting appropriate sales tax on the sale of medical marijuana.
- Reviewed and analyzed business licensing files to assess file completeness, eligibility of license applicants, sufficiency of the Division's background check process, and timeliness of application processing.
- Reviewed and analyzed data related to program funding and business licensing fee rates to assess the sufficiency of the Division's fee-setting practices.
- Reviewed and analyzed payment data to assess the Division's processes and procedures for authorizing and justifying Division expenditures.
- Reviewed and analyzed sales tax information from Fiscal Years 2011 and 2012 and sales tax audits conducted by Revenue to determine whether medical marijuana businesses paid sales tax.
- Interviewed industry stakeholders around the state, including four law enforcement agencies, four local governments, and six medical marijuana businesses.
- Reviewed basic medical marijuana program information from 18 states and the District of Columbia, all of which have passed laws legalizing the use of marijuana for medical purposes.

We relied on sampling techniques to support our audit work as follows:

- We selected a nonstatistical judgmental sample of 70 Division expenditures from Fiscal Years 2011 and 2012. The sampled expenditures included a range of low- to high-dollar amounts and totaled about \$1.2 million. We designed our sample to provide sufficient, appropriate evidence for our evaluation of the Division's financial management practices.
- We selected a nonstatistical random sample of 40 business license application files. The sample included files for 10 dispensaries, 10 grow operations, and 10 medical marijuana-infused products manufacturers. The sample also included five license renewal applications and five license applications submitted after the moratorium on new medical marijuana businesses ended in June 2012. The renewal and post-moratorium sample items included all types of medical marijuana

businesses. We designed our sample to provide sufficient, appropriate evidence for our evaluation of the Division's licensing process.

- We selected a nonstatistical random sample of 25 occupational license application files. The sample included five applications for key employee licenses and 20 applications for support employee licenses. We designed our sample to provide sufficient, appropriate evidence for our evaluation of the Division's licensing process.

The results of our sample testing were not intended to be projected to the entire population. Rather, sampled items were selected to provide sufficient coverage of areas that were significant to the objectives of this audit. Specific details about the audit work supporting our findings, conclusions, and recommendations are described in the remainder of the report.

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Licensing and Monitoring

Chapter 2

Having first been authorized by House Bill 10-1284, the Medical Marijuana Enforcement Division (the Division) is a relatively new agency and is charged with regulating an emerging industry, medical marijuana. The newness of the medical marijuana industry has created significant challenges for the Division in managing its regulatory activities effectively and efficiently. According to Division staff and Department of Revenue (Revenue) management, one of the biggest challenges facing the Division has been determining the size of the industry that the Division would ultimately have to oversee. The uncertainty about the size of the medical marijuana industry has complicated the Division's efforts to effectively perform its duties. Specifically, for an oversight agency like the Division, determining the scope of its work and the resources (e.g., staff and overall funding) needed to meet its statutory duties depends largely upon knowing the population of businesses to be regulated. The Division had estimates of medical marijuana businesses that had opened before House Bill 10-1284 passed, but it did not know how many businesses would apply for a license from the Division, how many would qualify for licensing, or how many would remain in operation. In addition, since the program began, some local jurisdictions have decided to ban medical marijuana businesses within their borders.

Although about 2,400 medical marijuana businesses (i.e., dispensaries, grow operations, and medical marijuana-infused product manufacturers) have applied for a license since the Division's inception, as of October 2012 there were only about 1,440 businesses still subject to Division regulations. These businesses either (1) have approved licenses from the Division or (2) have pending applications with the Division but applied by the "pre-moratorium" deadline of August 1, 2010, and are therefore allowed by statute to operate while their applications are pending. The following table shows the total number of medical marijuana business applications received, approved, pending, denied or withdrawn, and revoked or surrendered since 2010 when the Division was created.

Medical Marijuana Enforcement Division					
Status of Medical Marijuana Business License Applications Received Since Division's Inception					
Application Category	Total Applications Received	Approved Licenses	Pending Applications	Denied or Withdrawn Applications	Revoked or Surrendered Licenses
Pre-Moratorium Applications Received by August 1, 2010¹	2,353	478	960	913	2 ³
Post-Moratorium Applications Received on or after July 1, 2012²	26	-	26 ⁴	-	-
Total	2,379	478	986	913	2
Source: Office of the State Auditor's analysis of data provided by the Medical Marijuana Enforcement Division.					
¹ Status of pre-moratorium applications is as of October 2012.					
² Status of post-moratorium applications is as of December 2012.					
³ As of October 2012, no licenses had been revoked. Two businesses voluntarily surrendered their licenses.					
⁴ Pending post-moratorium applicants are not permitted to operate until the state and local licenses have been approved [Section 12-43.3-310(2), C.R.S.].					

The passage of Amendment 64 in November 2012, which decriminalized the recreational use of marijuana, will add to the Division's challenges with determining the size of the medical marijuana industry. It is possible that some current medical marijuana businesses will choose to transition to the recreational marijuana industry.

Although we acknowledge the difficulties that the Division has faced, we concluded overall that the Division has not done a sufficient job of managing its programs and its funds. Specifically, the Division has not adequately defined the full range of oversight activities it must perform or determined the resources it needs to implement the medical marijuana regulatory system envisioned by the General Assembly. In this chapter, we discuss the Division's efforts to license and monitor medical marijuana businesses and suggest ways in which the Division can make these processes more effective while ensuring that these businesses comply with statutory and regulatory requirements. In Chapter 3, we review the Division's strategic and financial management practices and make recommendations in areas such as fee-setting, controls over expenses, and strategic planning.

Licensing

The first step in overseeing the medical marijuana industry is to develop an effective licensing process to ensure that only eligible businesses enter into the industry. As discussed in Chapter 1, Colorado uses a dual-licensing system for medical marijuana businesses in which the State and local governments must both issue licenses for the business to operate. Our audit work focused only on

licensing activities at the state level, as our office is not authorized to audit local governments.

Section 12-43.3-401(1), C.R.S., gives the Division the authority to establish licensing programs for businesses that sell marijuana (dispensaries), grow marijuana (grow operations), and manufacture marijuana products (medical marijuana-infused product manufacturers), as well as for individuals who work in the industry (occupational licenses). The Division has created a licensing program for each of these types of licenses.

Overall, we found the Division has not developed an effective licensing program. For example, the Division has not processed business applications in a timely manner, resulting in more than 40 percent of the original business applications received by August 1, 2010 being in a pending status as of October 2012, or more than 2 years after the applications were submitted. For the applications that have been reviewed by the Division, we found that the Division's decision to approve a license or recommend approving a license has not always been substantiated by the evidence. Additionally, we found that the Division's occupational licensing program provides insufficient assurance that only individuals who have passed criminal history checks are employed in the medical marijuana industry.

This section includes recommendations for (1) improving the quality of the Division's review of business applications to ensure licensing of only eligible businesses, (2) streamlining the Division's business application review processes to achieve more timely decisions on applications, and (3) considering discontinuation of the Division's occupational licensing program and a greater role for businesses in ensuring that industry employees have passed requisite background checks. Although these recommendations are geared toward the Division's oversight of medical marijuana businesses, they may also provide useful guidance for Revenue's oversight of the recreational marijuana industry. Amendment 64 requires Revenue to begin processing license applications for recreational marijuana businesses by October 2013 and to issue licenses by January 2014.

Business Licenses – Quality of Application Review

Statute (Section 12-43.3-101, et seq., C.R.S.) lays out various requirements that businesses and their owners must meet to operate in the State's medical marijuana industry. These requirements are generally designed to ensure that medical marijuana businesses and their owners are financially sound, do not have a criminal background, and will not be a public nuisance. The table below summarizes these statutory requirements.

Colorado Medical Marijuana Industry Statutory Requirements for State Licensing	
Businesses	Business Owners
<ul style="list-style-type: none"> • Cannot be located within 1,000 feet of schools, colleges, or certain child care facilities unless local authorities have granted an exemption. • Must demonstrate proof (e.g., lease) that it is entitled to possession of the premises where it plans to operate. • Must have a \$5,000 corporate surety bond. • Must not employ, get assistance from, or be financed by a person whose criminal history indicates that the person is not of “good moral character.” • Must disclose all persons having a direct or indirect financial interest in the business. • Must obtain a license first from the applicable local jurisdiction and then from the State before it can operate.¹ 	<ul style="list-style-type: none"> • Must be Colorado residents for at least 2 years and be at least 21 years of age. • Must not have criminal history indicating that the owner is not of “good moral character.” • Cannot have a felony conviction in the previous 5 years or any felony conviction related to a controlled substance. • Cannot be delinquent on tax or child support payments or be in default on a student loan. • Cannot be a physician who recommends medical marijuana to patients for treatment, a law enforcement officer, or an employee of the Division or of local authorities that license medical marijuana businesses.
<p>Source: Office of the State Auditor’s analysis of the Colorado Revised Statutes (Section 12-43.3-101, et seq., C.R.S.).</p> <p>¹Businesses that applied for a state license by August 1, 2010, may continue to operate while the application is pending [Section 12-43.3-103(2)(c), C.R.S.].</p>	

The Division conducts a criminal and financial background investigation on the business and its owners and officers to determine eligibility for licensing. Owners and officers are required to provide personal history information and submit fingerprints for state and federal fingerprint-based criminal history checks [Section 12-43.3-307(2)(c), C.R.S.]. Applicants are also required to disclose information about anyone who has a direct or indirect financial interest in the medical marijuana business (Section 12-43.3-313, C.R.S.) so that these individuals can be investigated. To investigate an applicant’s financial background, the Division reviews credit reports, tax documentation, lease agreements, and start-up funding. The Division also requires owners to sign an attestation outlining the ownership structure of the business to ensure that the Division has investigated all relevant parties and that there are no hidden owners. After completing this extensive investigation, Division staff draft a report that makes a recommendation on whether or not the Division should license the business based on the investigator’s findings. The file then goes to the licensing supervisor for final processing.

Statute also outlines specific requirements for renewing licenses upon expiration. Specifically, the Division is required to conduct a fingerprint-based criminal history check for renewal applications, except that the Division may conduct a name-based criminal history check if the applicant has already twice submitted fingerprints to the Division [Section 12-43.3-307(2)(c), C.R.S.]. In addition, the Division must perform financial background checks to determine whether the renewal applicant is delinquent on tax or child support payments, is in default of a

student loan, or has failed to obtain a surety bond during the period in which he or she was licensed [Section 12-43.3-307(1)(g), C.R.S.].

Business License Review

We reviewed a non-statistical sample of 40 randomly selected business application files to assess whether the Division issues licenses only to eligible businesses in accordance with the statutory requirements outlined above. The files we reviewed included 35 new business applications and five renewal applications. Of the 35 new application files tested, as of December 2012:

- 10 had been approved for licensure.
- 1 had been denied licensure.
- 5 had withdrawn their applications.
- 19 were still pending a licensure decision.

Overall, we found that the Division's business license application review process does not provide adequate assurance that only eligible businesses have been licensed. In our review of 35 new application files, we found examples of businesses that were licensed despite evidence in the file suggesting they were not eligible for licensure. We also found evidence in the files of what appeared to be potentially disqualifying information. Specifically, investigators had raised concerns about an applicant's suitability for licensure, and there was no explanation from Division staff about why this information did not prevent licensure. In our review of five renewal applications, we found that the Division did not follow all of the required statutory requirements to determine the applicant's continued eligibility for license renewal. These issues are discussed in the bullets below.

New applications. For 13 (37 percent) of the 35 new business application files we reviewed, we found evidence in the file of potentially disqualifying information about the applicant, but no explanation from the Division staff about why the applicant was not ruled ineligible for licensure. Some files had multiple problems. The problems identified included:

- In three files, the businesses were located within 1,000 feet of a school. All three businesses disclosed their proximity to a school in their application and there was no evidence in the file to indicate the local jurisdiction had waived the 1,000-foot requirement, yet the Division did not disqualify them. Two of the businesses have been licensed by the Division. The license application for the third business is still pending with the Division, but Division staff have recommended the business for approval. While the Division was able to subsequently provide ordinances showing that local authorities in these cases had varied the allowable distance from a school, the files did not contain documentation confirming

that the local authority verified that the businesses were within the allowable distance.

- In one file, the business did not demonstrate lawful possession of the premises in which it was operating. The applicant provided a sublease agreement to the Division, but the accompanying lease stated that sublease agreements were not permitted. Division staff did not note this discrepancy and recommended the business for licensure.
- In one file, the business' surety bond had been cancelled 3 months prior to licensure. The Division received notification of the bond's cancellation prior to the license being issued. While the Division was able to subsequently obtain evidence from the business that the business did have a valid surety bond in place at the time of licensure, Division staff did not have this documentation at the time the license was issued.
- In two files, the businesses received licenses from the Division even though documentation in the file showed that their local licenses were expired at the time the licenses were issued.
- In five files, Division staff raised concerns about the applicants' suitability for licensure based on issues such as past criminal history (including felony arrests and nondisclosure of prior felony arrests), financial assistance from a potentially unsuitable person located in another state, and the applicants' involvement in alcohol and drug treatment classes. However, the Division staff recommended all five applicants for license approval (licenses have been issued in two cases; the remaining three cases are still pending) without documenting how these concerns did not disqualify the applicant under the "good moral character" clause.
- In four files, documentation in the files raised concerns about tax delinquencies that could have disqualified the applicants. However, the background investigation reports completed by staff did not mention the delinquencies, making it unclear whether the delinquencies were considered in the licensing decision. Three of these applicants have received licenses. Division staff recommended the fourth applicant for approval, although its application is still pending.
- In six files, some of the owners did not certify the ownership structure of the businesses. Division staff recommended all six for license approval (four are still pending) without confirming the owners of the businesses.

Based on the information above, we questioned whether four (40 percent) of the 10 files we reviewed in which the Division had already issued a new business license should have received the license.

Renewal applications. For all five of the renewal applications reviewed, we found that the Division failed to comply with all of the statutory requirements for reviewing renewal applications. At the time of our review, four of the five applications had been approved for renewal. Specific areas of concern included:

- **No background check conducted.** None of the five renewal applications contained evidence that the Division conducted a fingerprint-based criminal history check.
- **No local approval.** Three renewal applications did not contain evidence to show that the local license was approved or still valid. Two of these applicants were approved for renewal, and the third application is still pending.

The problems we found with the Division's business licensing practices raise concerns about whether only eligible businesses have been licensed to conduct business in Colorado's medical marijuana industry. Licensing businesses that do not meet the criminal history and financial background requirements for the medical marijuana industry could increase the risk that medical marijuana is diverted from the system and thereby undermine public confidence in the industry. In addition, with regard to school proximity, it is important for the Division to make the correct decision with a business's initial license application because, once licensed, a business cannot be subsequently denied licensure because of its proximity to a school [Section 12-43.3-308(1)(d), C.R.S.].

We found that the Division can improve its processing of business license applications by (1) strengthening its policies and procedures and (2) increasing the level of supervisory review over completed business license applications. We discuss each of these issues below.

Strengthening policies and procedures. The Division lacks policies and procedures for reviewing applications against statutory criteria in three key areas:

- **Proximity to schools.** The Division does not have policies and procedures in place to guide investigators in determining whether an applicant complies with the restriction that medical marijuana businesses cannot be located within 1,000 feet of a school. In addition, while the state application asks the applicant whether the business is located within 1,000 feet of a school, the Division does not have a process for acting on this information if the applicant answers "yes." For example, the Division could contact the local licensing authority to determine whether the locals have waived the 1,000-foot requirement or varied the allowable distance.
- **Background investigations.** The Division does not have policies and procedures to guide investigators in determining what types of information

(e.g., specific types of arrests or non-felony convictions, significant payment delinquencies) demonstrate that applicants do not meet the statutory “good moral character” standard. The Division also does not have policies or procedures on how to document dispositions about applicants’ eligibility when concerns have been raised about the applicant through the criminal and financial background check processes.

- **Renewal process.** The Division does not have processes to ensure compliance with statutory requirements for renewing licenses. Specifically, the Division does not currently conduct a criminal history review for renewal applications or verify local licenses before renewal.

Increasing supervisory review. The Division has not developed an adequate supervisory review process to ensure that businesses meet all requirements at the time of licensure. For example, the files we reviewed did not contain clear supervisory sign-offs indicating that the files had been reviewed, that the supervisor agreed with the investigator’s conclusions and recommendations for licensure, or that a final licensing decision had been made. In addition, as will be discussed in the next finding, the Division has had difficulty making final licensing decisions in a timely manner. As a result, it is not uncommon for a license to be issued months after the investigator completed the background investigation. In the intervening months, additional evidence could change the business’s eligibility. For example, in the exception above related to the cancelled bond, the bond cancellation occurred after the investigation of the applicant was complete but before the license was issued. Division staff reported that when issuing a license, they do not review the entire file a final time to confirm the eligibility decision.

Recommendation No. 1:

The Department of Revenue should ensure that the Medical Marijuana Enforcement Division (the Division) only licenses eligible medical marijuana business applicants by:

- a. Including steps in the Division’s application review process to confirm that the local licensing authority has verified that the business is within an allowable distance from any school.
- b. Including steps in the Division’s license renewal process to conduct criminal background checks of applicants, as required by statute, and to verify that the applicant has a valid local license.
- c. Establishing policies and procedures for determining the types of concerns raised in criminal history and financial background check investigations

that are grounds for denial and for clearly documenting dispositions on background checks when concerns have been raised.

- d. Establishing a well-documented supervisory review process to ensure that all minimum requirements are met prior to the Division issuing the license.
- e. Following up on the four cases identified during the audit in which auditors questioned whether the Division should have issued a license to the business, and determining the appropriate course of action.

Department of Revenue Response:

The Medical Marijuana Division will continue to focus its efforts on improving the processes by which it administers business licensing so that only eligible applicants obtain licenses.

- a. Agree. Implementation date: March 2014.

To ensure that proposed businesses locations are not within 1000 feet of any school, unless the local licensing authority has waived the distance restriction, the Division will enhance and improve its application review process as follows: (1) finalizing business licensing policies and procedure that specify the manner in which the Division will verify this statutory requirement with the local licensing authority, (2) amending the business application form as needed to comport with any new procedures, and (3) training staff to ensure that proper evidence of any distance waiver is maintained as part of the business file. Section 12-43.3-308(1)(d), C.R.S, authorizes local governments to pass ordinances to vary the 1,000 foot distance restriction. In those instances in which a local government has passed an ordinance varying the distance requirements, the license approval by the local authority is in effect the specific finding of fact that the license applicant has met all local requirements.

- b. Agree. Implementation date: March 2014.

To ensure that criminal background checks of applicants are conducted upon annual license renewal and that the applicant has a valid local license at the time of renewal, the Division will enhance and improve its renewal application review process as follows: (1) finalizing business licensing policies and procedures that specify the manner in which the Division will conduct review of renewal applications to ensure compliance with statutory requirements, (2) amending the business renewal application form as needed to comport with any new

procedures, and (3) training staff to ensure that proper evidence of criminal background investigation and local license approval are maintained in the business file.

- c. Agree. Implementation date: March 2014.

To ensure that disqualifying criteria for business licensure is clarified for investigative staff and applicants and that any resulting disqualifying criminal history or financial background information is adequately documented, the Division will enhance and improve its business application review process as follows: (1) finalizing business licensing policies and procedures that specify the manner in which the Division will conduct review of business applications to ensure compliance with statutory requirements, (2) promulgating rules that clarify those criteria that constitute unsuitability or a lack of good moral character, and (3) training staff as to the appropriate statutory and regulatory disqualifying criteria and the manner for recommending license denial.

- d. Agree. Implementation date: March 2014.

To ensure that final supervisory review of business applications is complete and well-documented, the Division will finalize business licensing policies and procedures that will specify the supervisory review process.

- e. Agree. Implementation date: May 2013.

To ensure that the four business licenses identified by the State Auditor are re-reviewed for statutory compliance, either for the distance restriction from a school or for local approval, the Division will contact each respective local licensing authority for verification. If verified, the Division will complete its business file with the necessary documentation, including documentation such as a copy of the local ordinance varying the distance restriction or a copy of the local license issued by the local licensing authority. If there remains an issue of statutory non-compliance, the Division will make the appropriate administrative notice to the licensee.

Business Licenses - Timeliness of Application Decisions

Making timely decisions about license applications is an important goal for any regulatory agency because delayed processing can have a negative impact on individual businesses, the industry as a whole, or communities. For the medical marijuana industry, these potential negative impacts differ based on when the business submitted its license application. Specifically, statute allows pre-moratorium businesses that submitted their licensing applications by August 1, 2010 (when the moratorium on new business applications was effective), to operate while their applications are pending with the Division [Section 12-43.3-103(2)(c), C.R.S.]. As a result, businesses that may not ultimately be able to comply with the statutory requirements for the medical marijuana industry can still operate until the Division completes its review of their applications and makes licensing decisions. Conversely, statute does not allow post-moratorium businesses that submitted applications after the moratorium on new applications ended in June 2012 to operate while their applications are pending with the Division. This means that delays in the Division's process prevent these businesses from operating and recouping their owners' investments.

We analyzed data from the Division's information system and from the 40 files in our file review discussed in the previous finding to determine the amount of time that the Division has taken to make licensing decisions for both pre- and post-moratorium business applicants. According to information provided to applicants, the Division intended to make decisions on all pre-moratorium applications by the end of Fiscal Year 2011. Additionally, House Bill 10-1284 required the Division to consider using temporary staff during Fiscal Year 2011 to help ensure the completion of background checks. However, we found that the Division did not meet this goal of completing application review the first year, even with the use of temporary staff, and has taken almost 2 years on average to issue final licensing decisions on business applications. We discuss our results below.

System data. Using data from the Division's My License Office (MyLO) system, we calculated that it has taken the Division an average of 688 days, or about 23 months, to approve licenses for 480 pre-moratorium applications. The shortest approval time was more than 1 year at 436 days, and the longest approval time was more than 2 years at 807 days. MyLO does not capture the date of denials, so we could not analyze the timeliness of those decisions. Further, out of about 2,400 pre-moratorium applications, the Division has approved or denied only 622, or about 26 percent, of the pre-moratorium applications as of October 2012. The rest of the applications were still pending (41 percent) or were voluntarily withdrawn by the applicant (33 percent). The chart below shows the status of all pre-moratorium applications as of October 2012.

Medical Marijuana Enforcement Division Status of All Pre-Moratorium¹ Business Applications October 2012					
Business Type	Approved	Denied	Withdrawn	Pending	Total
Dispensary	256	57	223	278	814
Grow Operation	188	73	410	551	1,222
Medical Marijuana- Infused Product Manufacturer	36	12	138	131	317
TOTAL	480²	142	771	960	2,353
Percent of Total Applications	20%	6%	33%	41%	100%
Source: Office of the State Auditor's analysis of data provided by the Medical Marijuana Enforcement Division.					
¹ Pre-moratorium applications were those applications submitted by August 1, 2010.					
² Approved total includes two applications that were originally approved, but the businesses subsequently voluntarily surrendered their licenses.					

The Division received 26 post-moratorium business license applications during the first half of Fiscal Year 2013 (July—December 2012). We found that all of these applications were still pending as of December 2012 with an average wait time of 91 days and counting. The amount of time these files have been pending ranged from 24 to 157 days.

File review data. MyLO captures the date on which the Division receives an application and the date on which it issues a license. However, MyLO does not capture dates related to interim steps, such as when the Division completes its background investigation or contacts the local approving authority to verify a local license. We used data from the 40 files in our business application file review to capture these dates and determine the timeliness of these interim steps. We found there were significant delays on the Division's part both in completing the criminal history and financial background checks and in issuing the license once the background checks were complete. Tasks that the Division must complete after completing its background checks often include performing an on-site inspection of the business and verifying that the business has a local license. For approved pre-moratorium applications from our file review sample, it took an average of 451 days to complete the background investigation and an average of an additional 251 days to issue the license once the background investigation was complete.

We determined that the delays shown above are largely the result of (1) performance of an on-site inspection before licensure, (2) verification of local license approval, (3) resolution of "problem" applications, and (4) the lack of internal policies or goals for ensuring timely application processing. We discuss the first three issues in this finding. The fourth issue will be discussed in Chapter 3 in connection with Recommendation No. 10.

Pre-licensing inspections. The Division conducts an on-site inspection of businesses typically after completing its background investigation and before issuing a license. The purpose of the inspection is to verify that the business is compliant with statutory and regulatory requirements, such as having a video surveillance system and not cultivating more marijuana plants than authorized. These on-site inspections create a significant amount of work for the Division. Specifically, staff reported to us that each inspection takes between 4 to 6 hours to complete, depending on the type of license. We estimate that inspecting all of the approximately 2,400 pre-moratorium applicants would take about 12,300 hours, which equals the work of six full-time equivalent staff in a year. The number of Division staff available to perform these on-site inspections has been as high as 19 but has been reduced to 10 as of February 2013. However, because these staff are also responsible for other licensing and monitoring activities, such as performing background investigations, their time available to conduct on-site inspections is limited.

The Division should consider eliminating the on-site inspection as part of its licensing process. Statute does not require the Division to perform these inspections and, with nearly 1,000 pending applications, it is unclear how much time the Division will take to work through this backlog. It may be more effective in the long run for the Division to issue licenses in these pending cases based on the findings of the background investigation and then conduct risk-based on-site inspections of the licensed businesses as part of a comprehensive monitoring program. Statute gives the Division the authority to levy fines and revoke licenses if these inspections find that the business is noncompliant with applicable laws and regulations. We discuss the Division's monitoring activities in more detail later in this chapter.

Verification of local approval. Division staff report that difficulty in verifying local approval of licenses has contributed to significant delays in their processing of applications. For example, as part of our review of 40 business files, there were 22 files that contained evidence that the Division had requested the status of the local license. However, as of December 2012, the Division had received a response from the local licensing authority for only 14 (64 percent) of those requests. The Division does not track the date it sends local verification requests in its files or its information system, so it was difficult for us to determine how much time the local authorities take to verify their license approval. We were able to find data in two of the files we reviewed indicating that the Division waited 268 and 242 days, respectively, for a response on local verification. As of October 2012, data from the Division's information system showed that 179 (19 percent) of the pending 960 pre-moratorium applications were classified by staff as cases in which the Division was waiting to receive verification of local approval.

A lack of clarity about how the licensing processes of the Division and local authorities should work together is largely responsible for the delays associated with local verification. As discussed previously, statute contemplates a licensing

system in which local authorities issue their licenses before the Division and specifically requires the Division to only issue a state license once “the local licensing authority has approved the application for a local license and issued a local license” [Section 12-43.3-305(2), C.R.S.]. In most cases, though, it appears that local authorities and the Division conduct their licensing reviews concurrently, which statute allows, and the Division sends the state license to the local authorities before the local license has actually been issued. Local authorities we spoke to reported to like this process because it allows the local authorities to align the effective dates of the local and state licenses. Division staff also reported that this is how the process works for liquor licensing. However, the process appears not to align with statute.

In addition, although the Division reports that it has met extensively with local jurisdictions to discuss this process, the Division has not laid out policies and procedures for how communication and coordination with local authorities on licensing activities should occur, even though statute authorizes the Division to promulgate regulations providing instructions to local licensing authorities [Section 12-43.3-202(2)(a)(III), C.R.S.]. The Division also has no policies and procedures for how Division staff should inquire about the status of a local license or document the status or communication with the local licensing authority in the application file.

Revenue reported that it plans to seek legislation to “decouple” the state licensing process from the local licensing process. If passed, this statutory change would allow the Division to move ahead with licensing businesses regardless of the status of the local license and would put the responsibility on the business to ensure that both state and local licenses had been obtained before operation. This statutory change could greatly assist the Division in achieving more timely review of licensing applications.

Problem applications. As of October 2012, the Division categorized nearly 120 (13 percent) of the 960 pending pre-moratorium applications as “problem applications” and another 20 (2 percent) as those that were “pending a voluntary withdrawal.” All of these files have been pending since the August 1, 2010, pre-moratorium application deadline and are, therefore, significant contributors to the problems with the timeliness of the Division’s licensing process. In general, these applications represent cases in which the Division discovered a problem during its investigation of the business that would likely lead to a denial of the application, but the final decision has not been made.

Staff indicated that the Division tries to encourage applicants with problem applications to voluntarily withdraw the application. According to staff, the advantage to the applicant of voluntarily withdrawing the application is that a denial does not become part of the applicant’s “permanent record,” which could adversely affect the applicant’s ability to obtain other licenses in the future from Revenue’s enforcement divisions. In addition, a withdrawn application can save

time for the Division because applicants have the statutory right to appeal license denials in a hearing. We noted that as of March 2013, eight businesses initially denied licensure by the Division had requested an appeal hearing.

The Division's preference for encouraging applicants to withdraw rather than denying their applications is concerning for two reasons. First, statute [Section 12-43.3-306(1), C.R.S.] requires the Division to deny an application in certain situations, such as when "the premises on which the applicant proposes to conduct its business does not meet the requirements of the [Colorado Medical Marijuana Code]." We did not systematically review the Division's problem applications. However, two of the problem applications were part of our 40-file sample of business applications, and we found that both applications should have been denied. Second, statute [Section 12-43.3-306(2), C.R.S.] requires the Division to provide written notice of the reasons for the denial. This notice provides the applicant with due process by ensuring that the Division is denying the application for appropriate reasons. The Division's reliance on voluntary withdrawals instead of denials, therefore, may reduce the transparency of its licensing process.

The Division does not have policies and procedures to guide staff in determining the appropriate use of application denials and withdrawals. As a result, the Division cannot ensure that applications are denied promptly when appropriate and preserve the due process rights of applicants.

Recommendation No. 2:

The Department of Revenue should improve the timeliness of the Medical Marijuana Enforcement Division's processes for licensing medical marijuana businesses by:

- a. Discontinuing pre-licensing on-site inspections as part of the initial licensing process and instead conducting risk-based on-site inspections as part of ongoing monitoring of licensed businesses, as discussed in Recommendation No. 4.
- b. Aligning license issuance with statutory requirements to only issue a state license once the local license has been issued or seeking statutory change, and clarifying in regulations, and policies and procedures as appropriate, the process for confirming and documenting local approval.
- c. Developing policies and procedures around the use of application denials and withdrawals.

Department of Revenue Response:

The Medical Marijuana Division will continue to focus its efforts on improving the processes by which it administers business licensing so that it is able to approve or deny applications on a timely basis.

Agree. Implementation date: March 2014.

- a. The Division agrees to evaluate the effectiveness of discontinuing the on-site pre-licensing inspection as a precursor to licensure. That evaluation will include developing a set of risk-based criteria by which to assess current and future applicants. Those determined to be of low risk, as it relates to statutory noncompliance, will be approved without the pre-license inspection, and will be scheduled for inspection in the first license year. Those found to be of higher risk will still be subject to the pre-licensing inspection. The Division will also implement a random pre-licensing inspection program to test the efficacy of the established risk criteria.
- b. The Division agrees to clarify in its rules and policies and procedures, as appropriate, the process for confirming and documenting local approval. Rules will provide better instruction to local authorities as to the time and manner of reporting local license approval of new and renewal applications. The Department will explore statutory changes concerning the interaction of state and local licensing authorities to improve the efficiency and effectiveness of the licensing process for medical marijuana establishments.
- c. The Division agrees to develop policies and procedures related to the manner in which it proposes application denial and also the manner in which it accepts application withdrawals.

Occupational Licenses

Statute requires all owners, officers, managers, and employees to pass a fingerprint-based criminal history check prior to being associated with, managing, owning, or working at a medical marijuana business [Section 12-43.3-310(4), C.R.S.] and prohibits a business from holding a license if employees have not passed a criminal history check [Section 12-43.3-307(1)(i), C.R.S.]. For business owners and officers, this fingerprint-based criminal history check is administered by the Division as part of the business licensing process discussed in the previous finding. For managers and employees, the fingerprint-based criminal history

check is also currently administered by the Division as part of its occupational licensing process.

Statute allows, but does not require, the Division to develop an occupational licensing program for individuals who work in the medical marijuana industry [Section 12-43.3-401(1)(d), C.R.S.]. Since May 2011, the Division has administered an occupational licensing program for (1) individuals who play a "support" role in a medical marijuana business, such as a sales clerk; (2) individuals who play a "key" role in a business, such as managers and bookkeepers; and (3) vendors, such as laboratory or security system contractors. Regulations require a person who is directly involved with marijuana (e.g., cultivating, dispensing, selling, and delivering) to obtain an occupational license before being employed by or under contract with a medical marijuana business.

As part of its occupational licensing program, the Division conducts both a financial background check of each occupational license applicant and a fingerprint-based criminal history check. Statute [Section 12-43.3-307(1), C.R.S.] prohibits certain individuals from holding a license, including those that have failed to pay taxes, are delinquent on student loan debt or child support, or who are not of good moral character. As a result, before issuing a license, the Division checks the applicant's credit history, the State's taxation system, and the Department of Human Services' child support database, as well as requesting confirmation from the federal Internal Revenue Service (IRS) of no outstanding balances.

Occupational License Review

We reviewed a non-statistical sample of 25 randomly selected occupational licensees that submitted applications between May 2011 and September 2012 to determine whether the Division issued licenses only to individuals who passed the aforementioned criminal history and financial background checks. Because the Division is not required to have an occupational licensing program, we also assessed the overall value of the Division's licensing process for identifying individuals who do not qualify to work in medical marijuana businesses.

Overall, we found that the Division's occupational licensing program is not an efficient and effective method for determining eligibility to work in the medical marijuana industry. Specific concerns we identified include (1) the issuance of licenses before the results of the background checks were known, (2) an inefficient and inequitable process used to accept license applications, and (3) weak controls over sensitive information. We discuss each of these issues below.

Issuance of licenses before background check results known. The Division's occupational licensing process does not provide assurance that prospective

medical marijuana industry employees have passed criminal history and financial background checks before being issued licenses. Specifically, we found that:

- For 22 (88 percent) of the 25 occupational licensing files reviewed, the Division issued a license to the applicant before the Division received the results of the fingerprint-based criminal history check. In six of these cases, the applicant disclosed a prior arrest history on the application.
- For nine (36 percent) of the 25 occupational licensing files reviewed, the Division issued a license to the applicant before the Division received confirmation that the applicant had no outstanding balances with the IRS or the State. In one of the nine cases, the IRS responded to the Division after the license was issued that the applicant had an outstanding IRS balance. After more than 15 months, the Division still had not taken any action on this file, such as to review the applicant's continued eligibility for an occupational license.
- For seven (28 percent) of the 25 occupational licensing files reviewed, it was unclear how the applicant met the "good moral character" standard. Statute [Section 12-43.3-307(1)(b), C.R.S.] prohibits individuals from holding any license issued by the Division if they have a criminal history that indicates that the person is not of "good moral character." The files of the seven applicants included documentation showing prior arrests, including one case in which the applicant had been arrested for felony aggravated robbery and felony menacing with a deadly weapon. However, the Division issued licenses without documenting why these arrest histories did not disqualify the applicants under the "good moral character" standard.

Inefficient and inequitable process. The Division's occupational licensing process is cumbersome and does not provide equal access to all applicants. Specifically, the Division requires all occupational license applicants in the state to apply in person at the Division's Denver office. Further, applicants must make an appointment to apply for a license so that Division staff can fingerprint the applicant. However, at the time of our audit, the Division had not taken new occupational licensing appointments in the previous 6 months, which creates a burden because individuals cannot legally work at a medical marijuana business without a license. For example, one medical marijuana business owner from the Western Slope reported contacting the Division in June 2012 to make appointments for his employees and was told that appointments were not available until January 2013. The owner also reported that the Division later postponed those appointments to February 2013.

In addition, while the Division's official policy is to require appointments for getting fingerprinted for an occupational license, Division staff reported and we

observed that some occupational license applicants are assisted on a “walk-in” basis without appointments. At the time of our audit, the Division did not advertise the possibility of helping applicants on a walk-in basis, and Division management was not aware of the practice. However, one medical marijuana business we spoke to knew about the unofficial walk-in policy and told us that new employees are sent to the Denver office to “sit there for a week if needed” until Division staff help them. After we discussed this issue with the Division, it began publicizing the availability of walk-in assistance on its website in February 2013.

Weak controls over sensitive information. For nine (36 percent) of the files reviewed, the Division could not locate documents associated with the applicant’s file. In two cases, the Division could not locate the applicant’s original application materials. In the other seven cases, the Division could not locate the applicant’s fingerprint check results. The missing documents contained sensitive information such as social security numbers and past criminal history, if applicable. Because of the missing documentation, we could not conclude on the reasonability of the Division’s decision to license these nine applicants.

Future of the Licensing Program

The problems we identified raise significant concerns about the effectiveness of the Division’s occupational licensing process in identifying factors that should disqualify individuals from working in medical marijuana businesses. In addition, the inefficiency of the Division’s licensing process makes it difficult for businesses to comply with statutory requirements. The Division could take steps to improve its occupational licensing system. However, because the Division is not required to issue occupational licenses, we concluded that a better option would be for the Division to discontinue its occupational licensing program and instead focus on streamlining the process for ensuring that employees of medical marijuana businesses pass a fingerprint-based criminal history check. We reached this conclusion based on evidence suggesting that (1) the number of potential employees being screened out by the Division’s licensing process is low, (2) the Division may not have chosen the best model upon which to base the occupational licensing process, (3) the Division would likely need to raise its application fees significantly to adequately cover the costs of its licensing process, and (4) medical marijuana business owners have a strong incentive to make good hiring decisions. We discuss this evidence below.

Denial rates. We analyzed the Division’s occupational licensing data to determine approval and denial rates. As the table below shows, the Division only denied 3 (<0.1 percent) of the approximately 5,600 applications submitted during the period of May 2011 through September 2012. Another 199 (about 4 percent) applications were withdrawn voluntarily by the applicant, which may indicate that the applicant expected that the application would be denied.

Medical Marijuana Enforcement Division					
Occupational License Approval Rates by Type of License					
May 2011 Through September 2012¹					
	Support	Key	Vendor	TOTAL	Rate
Approved	3,700	1,115	44	4,859	86.7%
Denied	3	--	--	3	< 0.1
Withdrawn	188	11	--	199	3.6
Pending	452	78	13	543	9.7
TOTAL	4,343	1,204	57	5,604	100.0%
Source: Office of the State Auditor's analysis of data from the Medical Marijuana Enforcement Division.					
¹ License data provided as of September 10, 2012.					

Licensing model. The Division based its occupational licensing model on a similar system used by the Division of Gaming at Revenue. The rationale behind this model is that the public views the risks of corruption or deceit in these industries as being significant and requiring strong oversight. Since the Division established its occupational licensing model, however, voters have approved Amendment 64 to decriminalize the recreational use of marijuana. Amendment 64 requires Revenue to regulate the recreational marijuana industry similar to how it regulates the alcohol industry in Colorado. Employees of alcohol-related businesses are not required to obtain licenses from Revenue. We did not find evidence to indicate that there will be significant differences in terms of risk between the recreational and medical marijuana industries, which suggests that requiring medical marijuana employees to obtain licenses may not be necessary.

Need to raise fees. The Division does not generate enough revenue from its fees for "support" licenses to cover its costs for processing those applications, which comprised 77 percent of all occupational license applications received from May 2011 to September 2012. Specifically, Division staff estimate that it takes at least 5 hours to process an occupational license application, regardless of type. The licensing fee for a support license is \$75, of which \$46.35 goes to the Colorado Bureau of Investigation (CBI) for running the background check and providing flagging service to notify the Division of subsequent arrests. That leaves less than \$30 (approximately \$6 per hour of work) to cover the Division's costs of processing each application. We reviewed the salaries of all staff involved in processing support licenses and found that they all earn significantly more than \$6 per hour.

Incentives for business owners. Medical marijuana business owners we interviewed also questioned the value of having the Division involved in determining an individual employee's suitability to work in the industry because business owners have a strong incentive to make good hiring decisions. Further, they argued that if an owner has passed all the rigorous background checks required for licensing the business, then the Division should be able to rely on the owner to hire suitable employees.

If the Division eliminates its occupational licensing program, it will still need to establish an efficient and effective process for ensuring that prospective medical marijuana employees pass the statutorily required fingerprint-based criminal history check. CBI already provides these types of checks for private employers, so the Division could adopt that model. Specifically, the Division could require that businesses take the lead in ensuring that their employees pass a fingerprint criminal history check by:

- Having prospective employees get fingerprinted at their local law enforcement office.
- Submitting the fingerprint cards to CBI.
- Reviewing the results from CBI and making a determination of the employee's suitability for employment based on criteria provided by the Division.
- Maintaining documentation to demonstrate compliance with criminal history check requirements. The Division could then use audits, on-site inspections, or other means to review this documentation for compliance.

The above approach would be more streamlined and less costly overall to the medical marijuana industry than the current licensing system. The main downsides of this approach are that an employer-conducted criminal history check (1) would include only the information from the State's criminal history database and not from the federal database since CBI is not permitted to release federal information to private employers, and (2) would be a one-time result since flagging and notification of subsequent arrests is a service available only for state agencies when required by statute. If the Division determined that access to federal information or flagging were important features for medical marijuana industry employees, then it could look to model its procedures after the child care industry. In that industry, child care businesses oversee the fingerprint process for their prospective employees and receive the results of the state criminal history check from CBI. The Division of Early Care and Learning at the Department of Human Services also receives the results of the state criminal history check from CBI, as well as the federal criminal history check, and any notices of subsequent arrests. The Division of Early Care and Learning reviews the state and federal criminal history results for any mandatory disqualifiers and informs the business, who is responsible for making the hiring decision.

For this system to work in the medical marijuana industry, the Division would need processes in place to receive and review federal criminal history check results from CBI, report the results to the business, and ensure that it follows up on notices of subsequent arrests that it receives from CBI. While the Division currently has a process in place to receive and review results of criminal history checks from CBI, it does not currently inform the employer of the results, and we found that the Division does not have a process in place to follow up on subsequent arrest notifications. For example, in one of the 25 reviewed files, the

Division received notification from CBI that a licensee had been arrested for kidnapping, false imprisonment, and cruelty toward a child. However, at the time of our file review, which occurred 13 months after the notification from CBI, the Division had not taken action on the case, such as alerting the employer of the licensee's arrest or considering revoking the license.

Recommendation No. 3:

The Department of Revenue should improve the Medical Marijuana Enforcement Division's (the Division) process for ensuring that employees of medical marijuana businesses pass fingerprint-based criminal history checks before beginning work at medical marijuana businesses by:

- a. Evaluating discontinuation of its occupational licensing program.
- b. Determining how to best ensure that prospective employees have passed a fingerprint-based criminal history check prior to working in the medical marijuana industry, as required by Section 12-43.3-310(4), C.R.S., including defining what it means to "pass" a criminal history check and revising regulations to reflect those practices. The Department of Revenue should also work with the General Assembly as necessary to revise statute to reflect the Division's new process.
- c. Monitoring through audits, on-site inspections, or other means to ensure that medical marijuana businesses are complying with requirements established through part "b."

Department of Revenue Response:

The Medical Marijuana Division will continue to focus its efforts on improving the processes by which it administers occupational licensing so that licensing functions are efficient and effective and that only eligible applicants obtain licenses.

Agree. Implementation date: March 2014.

- a. To ensure that the Division's occupational licensing program is efficient and effective in achieving the policy objectives established by the Colorado General Assembly, the Division will work with stakeholders and policymakers to determine the best course of action for the program. While the Division believes that occupational licensing is foundational to the program's enforcement integrity, the Division will include exploring the option of discontinuing the program in its discussion with stakeholders.

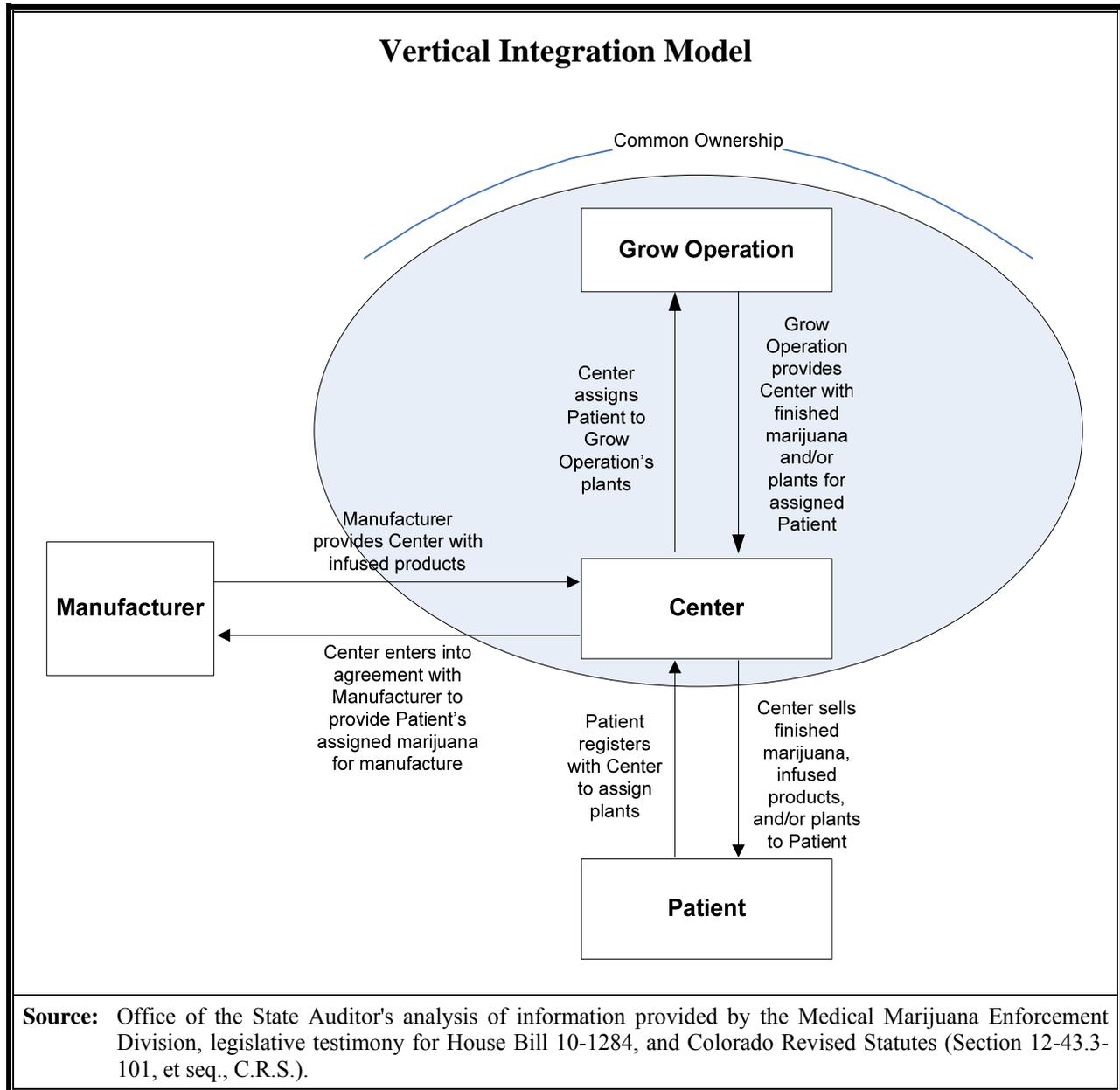
- b. To ensure that prospective employees of business licensees have passed a fingerprint-based criminal history check prior to working in the medical marijuana industry and to better define what it means to “pass” a criminal history check, the Division will enhance and review the application review process as follows: (1) finalizing occupational licensing policies and procedure that specify the manner in which the Division will conduct the appropriate investigation of applicants to ensure compliance with statutory requirements, (2) amending the occupational license application form to comport with any new procedures, (3) training staff to ensure that proper evidence of criminal background investigation approval are maintained in the occupational file, and (4) promulgating rules that clarify those criteria that constitute unsuitability or a lack of good moral character.
- c. To ensure that medical marijuana businesses are complying with requirements established through part “3b”, above, the Division will enhance its monitoring activities of licensed businesses during inspections and audits by including a review of employees working in the establishments.

Monitoring

In passing House Bill 10-1284, the General Assembly sought to create a regulatory scheme for medical marijuana that would help ensure that marijuana produced by the State’s licensed medical marijuana businesses would be used only by patients on the State’s medical marijuana registry. Specifically, statute set up a “vertical integration” model for medical marijuana that creates a direct relationship between:

- Patients and their designated dispensaries, in which a dispensary’s inventory is limited to the total amount of medical marijuana authorized for all of its patients.
- Dispensaries and the grow operation, as demonstrated by common ownership and a requirement that dispensaries grow at least 70 percent of the medical marijuana they sell.
- Medical marijuana-infused product manufacturers and dispensaries, in which the manufacturers must have contracts with dispensaries that specify the amount of medical marijuana they will purchase from the dispensaries and the number of products that the manufacturer will make. Manufacturers are also limited to having 500 marijuana plants at any given time.

The diagram below illustrates how the vertical integration model established by House Bill 10-1284 should work.



The intent of the vertical integration model is to ensure that the medical marijuana grown, processed, and sold in Colorado does not enter the recreational market or cross state borders. Recent news highlight this potential diversion threat. For example, a report released in August 2012 by the Rocky Mountain region of the federal High Intensity Drug Trafficking Area Program, which works to coordinate drug-control efforts among local, state, and federal law enforcement agencies, indicated that some marijuana from Colorado's medical marijuana industry

appears to have been be diverted by patients, caregivers, and dispensaries for recreational purposes.

The desire to create a vertically integrated regulatory model was also influenced in part by *Gonzalez v. Raich*, a 2005 U.S. Supreme Court case in which the federal government successfully prosecuted a California medical marijuana patient even though California state law allowed medical marijuana. The Supreme Court defended the federal government's authority to prosecute this patient by arguing that the medical marijuana grown by this patient affected the interstate marijuana market, which allowed the federal government to invoke the Commerce Clause and become involved in the case. As a result, establishing a tightly controlled, closed-loop system in which all medical marijuana cultivated, processed, and sold in Colorado is used only by legitimate medical marijuana patients and does not cross state lines appeared to be a means for averting federal prosecution of Colorado's medical marijuana businesses and patients.

To implement this regulatory vision of House Bill 10-1284, former Revenue officials proposed creating a heavily regulated system that would track medical marijuana from "seed-to-sale." According to news reports at the time, the seed-to-sale model would allow regulators to track medical marijuana "from the time the seed goes into the ground to the time the plants are harvested, cultivated, processed, packaged and stored," which no other state had done previously. It was through this intense oversight that marijuana from Colorado's medical marijuana industry was supposed to remain within the industry and not enter the recreational market or cross state borders.

We reviewed the Division's efforts to implement the vertical integration model for monitoring the supply of medical marijuana in Colorado. We found that the envisioned seed-to-sale model does not currently exist in Colorado, and as discussed later, may not make sense. Features of the seed-to-sale system were to include the use of a computerized plant tracking system, 24-hour video surveillance of medical marijuana businesses, extensive paperwork requirements to track the flow of medical marijuana, and recurring audits by Division staff to determine if businesses have excess marijuana plants or products. However, these elements either do not exist or are not being used effectively by the Division, as described below.

Plant tracking system. The Division does not have a system in place to track the inventory of medical marijuana plants and finished products. Tracking this inventory was intended to allow Division staff to determine whether all medical marijuana plants were being used only to produce medical marijuana product for the use of medical marijuana patients. The Division awarded a contract in Fiscal Year 2011 to develop a seed-to-sale inventory tracking system that uses electronic tags. The proposed system would have tracked information about the number of approved plants per patient and each stage of plant growth, distribution, and sale. The Division paid the contractor about \$1.1 million in Fiscal Years 2011 and

2012 for software to set up the system. However, due to financial difficulties that we discuss in more depth in Chapter 3, the Division has been unable to pay the remaining \$400,000 owed on the contract, and the system has not been implemented. In March 2013, the Division reported that it now has the funding and will implement the system by the end of Calendar Year 2013.

Video surveillance system. The Division does not have a video surveillance system in place to monitor medical marijuana businesses. Division rules require all medical marijuana businesses to install security camera systems with recording capabilities. The plan was for the Division to remotely monitor the businesses' security camera feeds to identify any potentially illegal activity, such as diverting medical marijuana to unauthorized uses. However, the Division has not purchased the necessary equipment to monitor these camera feeds because of a lack of funds. According to the Department, even if the funds were available, it has determined that this approach would not be feasible or a good use of Division resources.

Tracking forms. The Division does not review forms designed to track medical marijuana activities and inventories and ensure that medical marijuana is not being diverted from the system. The Division has 12 forms that businesses must complete periodically and either submit to the Division or maintain on-site. These forms include:

- Travel manifests, which the Division is supposed to approve before the business transports medical marijuana plants or products from its facility.
- Inventory count sheets, which track the grams of medical marijuana each business has on its premises every day that it is open to the public.
- Monthly patient lists, which track the number of patients that have affiliated with a particular dispensary.
- Reports tracking wholesale sales and purchases and retail sales to patients.

However, the Division reports that it does not review the forms that are submitted by businesses or the ones maintained on-site at the business.

Audits. The Division does not currently perform any audits of medical marijuana businesses to verify their inventories and ensure that the businesses do not possess excess marijuana plants or finished products. The Division hired staff to perform this type of audit but laid them all off toward the end of Fiscal Year 2012 because of its aforementioned financial difficulties.

We also found that the Division's current monitoring processes do not regularly determine compliance with other key features of the vertical integration model, such as the requirement that dispensaries grow 70 percent of the medical marijuana that they sell and that medical marijuana-infused product manufacturers have contracts in place with dispensaries specifying the amount of marijuana being sold to the manufacturer and the number of finished marijuana

products to be produced. In the spring of 2011 the Division did follow up with dispensaries that did not certify by September 2010, as required by statute, that they were growing at least 70 percent of the medical marijuana that they were selling, but the Division has not undertaken similar efforts since then.

Our audit results demonstrate that the Division needs to take steps to improve its ongoing oversight of medical marijuana businesses. In doing so, the Division may need to rethink its approach to monitoring overall. The envisioned seed-to-sale system appears to be based on a philosophy in which the Division monitors medical marijuana businesses at a micro-level (e.g., centralized plant tracking system and submission of travel manifests). Given the passage of Amendment 64, this micro-level monitoring approach may no longer be appropriate.

A more cost-effective approach could be for the Division to implement a risk-based monitoring system that assesses how well businesses are complying with key statutory and regulatory requirements, such as those related to the vertical integration model. As discussed earlier in this chapter, the Division currently conducts pre-licensing inspections of medical marijuana businesses. The Division's pre-licensing inspection process could serve as the basis for developing this comprehensive monitoring program.

As noted above, the Division laid off its audit staff in response to financial difficulties, which we will discuss in the next chapter. If staffing constraints present an obstacle to the Division's implementation of a comprehensive monitoring system as outlined above, statute [Section 12-43.3-701(1), C.R.S.] allows the Division to require businesses to obtain annual independent audits at the businesses' expense to determine compliance with applicable laws and regulations. If the Division chose this approach, it would need to develop an audit program for the outside auditors to follow and then review the audits to determine if there were any compliance issues Division staff needed to follow up on.

Recommendation No. 4:

The Department of Revenue should improve the effectiveness of the Medical Marijuana Enforcement Division's (the Division) monitoring activities by:

- a. Developing a comprehensive, risk-based compliance program that identifies which statutory and regulatory requirements will be tested for compliance at medical marijuana businesses.
- b. Providing guidance to medical marijuana businesses on the documentation required to demonstrate compliance with the key requirements identified in part "a."

- c. Developing a risk-based methodology for selecting medical marijuana businesses to monitor.
- d. Developing procedures for conducting the compliance reviews and/or requiring medical marijuana businesses to hire an independent firm to conduct audits of the business.

Department of Revenue Response:

Agree. Implementation date: March 2014.

- a. The Division has already laid some of the groundwork for developing a risk-based compliance program by creating some of the compliance programs to be utilized for assessing compliance with statutory and regulatory compliance. The Division will incorporate our compliance program into an overall strategic plan for the Division that will also include written policies and procedures.
 - b. The Division has initiated the regulatory reform process with existing medical marijuana regulations. The Division anticipates revising its regulations to simplify them and ensure that licensees clearly understand requirements. Additionally, the Division will explore other ways to share information with licensees that will enhance their level of compliance with both statutory and regulatory requirements.
 - c. The Division will develop a risk-based approach for the selection of medical marijuana businesses to receive compliance based inspections or reviews from the Division. This methodology and appropriate performance measures will be incorporated into the Division's overall strategic plan and written procedures. Division resources available for compliance related activities will help determine the number of compliance inspections to be completed during an established period and the risk-based methodology will assist the Division in determining which licensees to examine.
 - d. The Division will establish written procedures for conducting compliance reviews on medical marijuana businesses and will explore the feasibility of establishing requirements for medical marijuana businesses to contract with independent firms to perform agreed upon procedures reviews to determine compliance. There are many factors to consider in determining the feasibility of instituting such a requirement including the cost to licensees, the resources necessary to implement such a program and review reports and the need based on the level of resources available at the Division to conduct the appropriate level of compliance reviews.
-

Disposition of Unauthorized Marijuana

Statute allows the Division to take and destroy marijuana from medical marijuana businesses in two specific circumstances. First, under Section 12-43.3-602(4), C.R.S., the Division may take and destroy medical marijuana as a remedy for a disciplinary action against the business. Second, under Section 12-43.3-901(4)(o), C.R.S., businesses that cease operations must forfeit all marijuana and marijuana products to the Division for destruction. Statute [Section 12-43.3-602(7), C.R.S.] also directed the Division to promulgate rules by January 1, 2012, related to the taking and destruction of marijuana in connection with a disciplinary action.

We reviewed the Division's policies and procedures regarding the taking and destruction of marijuana to determine if they comply with applicable laws and regulations. Overall, we found that the Division does not comply with statute when taking marijuana related to disciplinary actions and has weak controls for ensuring that seized marijuana is destroyed properly. Below, we discuss these processes separately.

Taking of marijuana. We found that the Division does not use the prescribed statutory process to take marijuana in connection with a disciplinary process. As noted above, statute allows for the taking of marijuana as one possible remedy for a disciplinary action imposed against a medical marijuana business. The Division reported that it took and destroyed marijuana from businesses 40 times during Calendar Year 2012. In most cases, the documentation provided by the Division was not clear in explaining the circumstances that led to the taking and destruction of the marijuana, so we could not conclude how many of these cases represented disciplinary actions. Staff also reported taking as much as 15 pounds of finished marijuana product in a single incident, an amount that would have a value in the tens of thousands of dollars.

According to Division staff, when they determine that a business has too many marijuana plants or too much product than they are authorized to have, they will ask the medical marijuana business owner to sign a "voluntary surrender" form. We identified two concerns with the Division's use of the voluntary surrender process to take marijuana. First, the voluntary surrender form does not comply with the disciplinary process outlined in statute for taking marijuana. To impose a disciplinary action, statute requires the Division to complete an investigation, provide written notice of the investigation's findings, and give the business an opportunity for a public hearing to respond to the findings. The Division does not follow any of these steps in its voluntary surrender process. For example, the voluntary surrender form does not include any findings of fact substantiating that the business has more marijuana inventory than it is authorized to have based on its patient counts. The form also does not specifically inform the business owner that he or she can request a hearing to dispute the Division's findings or allow the owner to waive his or her right to a hearing.

Second, it is not clear how Division staff determine that medical marijuana businesses have unauthorized plants or finished products. As we noted in the previous finding, the Division does not have monitoring processes, such as a plant tracking system, that would allow staff to verify plant and patient counts. In addition, in one incident during Calendar Year 2012, a Division staff person reported taking about 11 pounds of unauthorized marijuana from a business. The staff person reported returning the marijuana to the business owner when the business owner found the documentation to prove that the business did not have unauthorized marijuana. This incident may have been avoided and the marijuana never taken if the Division had followed the more formal statutory process for taking marijuana in this type of situation.

We believe that the Division can ensure that its process for taking unauthorized marijuana complies with statute without being significantly burdensome on the Division's resources. Specifically, the Division could revise its voluntary surrender form so that it includes:

- Staff's specific findings of fact with regard to the amounts of unauthorized marijuana being held by the business and the methodology used by staff to determine the unauthorized amount.
- Confirmation that a supervisor has reviewed and approved the staff's findings.
- Language indicating that the business owner has the right to dispute the findings of fact in a formal hearing or can waive this right.

The General Assembly provided specific direction in statute for how the Division should take marijuana from a medical marijuana business that has violated applicable laws and/or regulations. Adding the elements above to the Division's current voluntary surrender process for unauthorized marijuana would better ensure that the Division is meeting these statutory requirements for taking marijuana.

Destruction of marijuana. We found that the Division has inadequate controls for destroying marijuana plants and finished marijuana products that have been seized from businesses. The method the Division uses for destroying seized marijuana depends upon its form. For marijuana plants, Division staff typically oversee destruction at the business's facility. For finished marijuana products, Division staff transfer the products either to an off-site incinerator or to an off-site storage facility where the marijuana is held until it can be taken for destruction. We identified two significant control weaknesses in the Division's process for transporting marijuana products from the business to either the incinerator or the storage facility. First, the documentation used to track these transfers is inadequate to ensure that the seized products are properly tracked. Once the business owner signs the voluntary surrender form, Division staff take the form and leave a copy with the business. However, the Division does not maintain any

aggregate inventory records for the marijuana in the storage facility showing the date and amounts of marijuana placed into or taken out of the storage facility. The Division also does not maintain records verifying that the marijuana plants or finished products have been destroyed.

Second, the storage facility used by the Division does not have the same security features as are required for medical marijuana businesses. For example, the storage facility has only one security camera aimed at the outside of the facility, whereas businesses are required to have an additional camera (or cameras, depending on facility size) to monitor the inside of the facility. Also, the storage facility uses residential-grade locks instead of the commercial-grade locks required for businesses.

It is important to note that we did not find evidence during the audit to suggest that any of the marijuana taken by Division staff has not been destroyed. However, the Division's weak controls over the taking and destruction of marijuana create significant risks for the Division. For example, by not following statutory provisions related to disciplinary actions, business owners may not understand their rights regarding a hearing and could be inappropriately pressured into giving up their marijuana without having the opportunity to explain why the marijuana should not be taken. Similarly, the lack of controls over the transport of seized marijuana provides an opportunity for the marijuana to be misappropriated.

Given these risks, the Division needs to improve the controls over how it takes and destroys marijuana. The Division does not have any written policies or procedures that specify how staff should take and destroy marijuana plants or finished products when the removal is related to a disciplinary action, even though statute required the Division to develop these rules by January 1, 2012. The Division also does not have written policies and procedures providing guidance to staff on how to determine that medical marijuana businesses have unauthorized plants or finished products.

Recommendation No. 5:

The Department of Revenue should improve the Medical Marijuana Enforcement Division's (the Division) processes for seizing and disposing of unauthorized marijuana by:

- a. Ensuring that Division staff take and destroy unauthorized marijuana plants and products found at medical marijuana businesses only in connection with a disciplinary action against the business, as outlined in statute.

- b. Promulgating rules providing guidance to staff on how to take and destroy marijuana plants and products and to determine whether medical marijuana businesses have unauthorized marijuana.
- c. Establishing an inventory control system to track marijuana from the time it is taken until it is destroyed.
- d. Strengthening the security of the facility used to store seized marijuana.

Department of Revenue Response:

Agree. Implementation date: March 2014.

The Medical Marijuana Enforcement Division will continue to improve and refine its processes for the taking and disposing of medical marijuana in the following two instances:

- (1) The Division's discovery of unauthorized medical marijuana in licensed premises, and
 - (2) A licensee's voluntary surrender of medical marijuana.
- a. In those instances where medical marijuana is found at medical marijuana businesses in violation of statutory or regulatory provisions (e.g. "excess" medical marijuana that cannot be verified through licensee patient records), the Division will establish clear policies and procedures to ensure that Division staff take the product only in conjunction with the disciplinary process contemplated in Section 12-43.3-602, C.R.S. Further, that upon final disposition of any disciplinary action, destruction of the medical marijuana taken only occurs upon final order of the state licensing authority.
 - b. In furtherance of the response in part 5a. above, the Division will promulgate rules to address the specific implementation of the provision in Section 12-43.3-602, C.R.S., thereby clarifying the requirements with staff and the regulated community. To assist staff in determining if there is excess medical marijuana on the premises, and how to take and destroy such marijuana, the Division will improve its enforcement training and enforcement policies and procedures so that staff have clarity as to how to make such determinations when conducting inspections and investigations, and the manner in which to take excess marijuana as part of the final recommendation for disciplinary action.
 - c. As part of implementing enforcement policies and procedures described in part 5b. above, the Division will develop and maintain an

internal evidence inventory control system to track marijuana evidence from the time that it is taken to the time it is destroyed.

- d. As part of implementing enforcement policies and procedures described in part 5b above, the Division will strengthen the security of the facility it uses to store medical marijuana that was seized or voluntarily surrendered.

Sales Tax Administration

In establishing the regulation of medical marijuana through House Bill 10-1284 and House Bill 11-1043, lawmakers included several provisions concerning the collection and distribution of sales tax revenue generated from the sale of medical marijuana.

For collections, the Medical Marijuana Code specifically requires licensed dispensaries to collect sales tax [Section 12-43.3-401(2), C.R.S.]. Grow operations and medical marijuana-infused product manufacturers do not collect sales tax because they do not make retail sales. Statute also requires that, before it can be licensed by the Division, a dispensary post a \$5,000 surety bond to guarantee the payment of state and local taxes [Section 12-43.3-304, C.R.S.]. Earlier in this chapter, we provided recommendations to the Division for improving controls to ensure businesses have a current surety bond in place before licensure.

On the distribution side, statute requires that the first \$2 million of sales tax revenue generated by dispensaries be appropriated to the Department of Human Services and the Department of Health Care Policy and Financing for substance abuse and mental health programs [Section 39-26-123(6), C.R.S.]. To ensure that the proper funds are appropriated to these programs, it is important that Revenue accurately determine the amount of sales tax revenues being generated by medical marijuana businesses. Revenue reported \$5.4 million in sales tax collections from dispensaries in Fiscal Year 2012.

To determine whether Revenue accurately tracks the amount of sales tax revenue generated by dispensaries, we conducted a data match of Revenue's underlying report used to estimate medical marijuana sales tax revenue with the Division's records of medical marijuana businesses. The results of our match revealed inadequate controls to ensure that Revenue accurately tracks sales tax from the 476 dispensaries that were operating in Colorado as of October 2012, as described in the bullets below.

- **Medical marijuana businesses not properly flagged in Gentax.** We found that 56 (12 percent) of the 476 dispensaries were not correctly identified as medical marijuana businesses in Gentax, Revenue's information system for tracking tax revenues. As a result, Revenue underreported sales tax revenue generated by these dispensaries by about \$760,000 for Fiscal Years 2011 and 2012 combined.
- **Not all medical marijuana businesses have a sales tax license.** We found no evidence that 16 (3 percent) of the 476 dispensaries had obtained a state sales tax license. In 10 cases, the dispensaries' business licenses were still pending with the Division, but the businesses were allowed to operate because they filed a pre-moratorium application. As a result, these dispensaries may not be remitting state sales tax for medical marijuana sales.
- **Not all medical marijuana businesses filed and paid sales taxes.** We found that 11 (2 percent) of the 476 dispensaries had not filed sales taxes in either Fiscal Year 2011 or 2012 and 12 (3 percent) dispensaries have not paid any sales taxes. There was no overlap in these two groups.

Revenue has an inefficient and ineffective process for reconciling the Division's records of medical marijuana businesses with Revenue's tax records in Gentax. For example, the application businesses use to apply for a sales tax number does not ask whether the business sells medical marijuana products, even though similar questions exist for alcohol and tobacco products. As a result, Revenue has to identify which businesses should be flagged as medical marijuana businesses by manually reconciling the Gentax system with the Division's records of medical marijuana businesses. Revenue staff then manually add a unique indicator to each medical marijuana business record in the Gentax system. However, our audit results above show that this step was not always done correctly.

Additionally, the Division has not effectively used its reconciliation process as a tool to ensure that dispensaries have sales tax numbers, file sales taxes, and remain in operation. For example, in seven cases, the Gentax system listed the dispensary as being out of business, but the dispensaries' applications were still pending with the Division. In 23 other cases, the Gentax system showed no sales taxes filed or paid by the businesses, but the Division's records indicated that the businesses were operating. The Division should use this information to help in its ongoing monitoring efforts of businesses. Finally, information from the reconciliation process that indicates that a dispensary may be operating but not filing sales tax could serve as a risk indicator for selecting dispensaries for sales tax audits.

The collection and distribution of sales tax from the sale of medical marijuana was important to policy makers in establishing a system for regulating medical

marijuana. Revenue needs to be able to provide assurance that medical marijuana dispensaries are paying required sales taxes and to accurately report on the total revenue generated from medical marijuana sales. This assurance may become more important when consumers have the option under Amendment 64 to shift their purchases to recreational marijuana instead of medical marijuana. This potential drop in sales for medical marijuana could bring its annual sales tax collections closer to the \$2 million threshold for funds that are to be dedicated to substance abuse and mental health programs, thereby increasing the importance of accurately capturing all medical marijuana-related sales tax collections.

Recommendation No. 6:

The Department of Revenue should ensure that it can accurately determine the amount of sales tax revenue generated annually from medical marijuana businesses by:

- a. Ensuring that medical marijuana businesses are properly flagged in the Gentax system for the purposes of reporting medical marijuana sales tax figures.
- b. Including a question on its sales tax application to identify medical marijuana businesses and then entering that information into the Gentax system up front.
- c. Following up on the 56 businesses that were not correctly identified in Gentax, the 16 businesses we identified with no evidence of a state sales tax license, and the 23 businesses we identified that did not file or pay sales taxes in Fiscal Year 2011 and 2012 to determine if taxes should have been paid.
- d. Implementing a process to periodically review the Medical Marijuana Enforcement Division's list of medical marijuana businesses for the purposes of ensuring that all have a sales tax number, are in the Gentax system, and that businesses the Division understands to be operating are filing sales taxes.

Department of Revenue Response:

- a. Agree. Implementation date: March 2014.

The Department agrees with this recommendation and will immediately begin evaluating alternatives within the GenTax system to implement this recommendation. The Taxation Line of Business will coordinate its efforts with the Medical Marijuana Enforcement

Division to ensure that all known businesses engaged in the retail sale of medical marijuana or marijuana-infused products are properly classified within the GenTax system.

- b. Agree. Implementation date: June 2013.

The Department agrees with this recommendation and will revise the current sales tax application form, asking the applicant to self-report whether or not they sell medical marijuana, adult-usage marijuana or marijuana-infused products.

- c. Agree. Implementation date: June 2013.

The Department agrees with this recommendation and will immediately begin its follow up on the 56 businesses identified by the State Auditor as not being properly categorized within GenTax, the 16 businesses for which the State Auditor found no evidence of a state sales tax license, and the 23 businesses the State Auditor identified as not having filed or paid sales taxes in Fiscal Years 2011 and 2012. The objective of our efforts is to ensure these accounts are properly sales tax licensed; determine if the business is a going concern, and if it is to bring them into voluntary compliance with filing and remittance obligations, or to take enforced compliance actions which could include audits of books and records or seizure of assets to satisfy liabilities.

- d. Agree. Implementation date: March 2014.

The Department agrees with this recommendation. The Medical Marijuana Enforcement Division and the Taxation Line of Business will develop a process and a procedure to perform periodic reviews focused on ensuring synchronization between the accounts contained in My License Office and GenTax.

Financial and Strategic Management

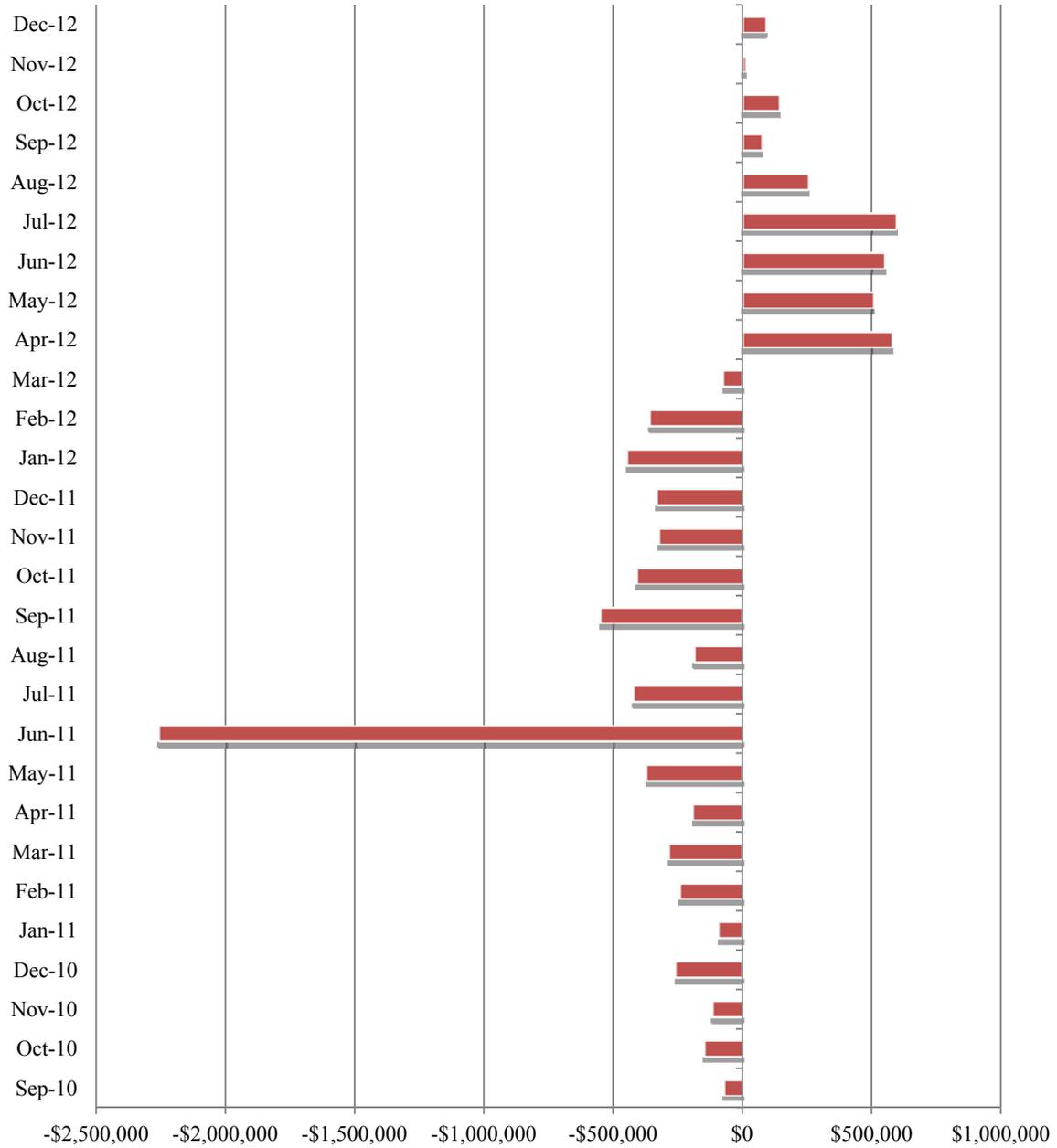
Chapter 3

The General Assembly has stressed the importance of increasing government accountability by having government agencies strategically manage their resources to achieve well-defined outcomes. Specifically, the State Measurement for Accountable, Responsive, and Transparent (SMART) Government Act (House Bill 10-1119) requires state agencies in Colorado to create overarching objectives for their work, develop plans to achieve these objectives, and allocate resources to implement these plans. Further, the SMART Government Act requires agencies to establish performance measures so that agencies can determine if they are meeting their objectives and allocating their resources effectively.

In Chapter 2, we discussed the difficulties that the Medical Marijuana Enforcement Division (the Division) has had in performing the licensing and monitoring activities required to implement the medical marijuana regulatory system envisioned by the General Assembly. In this chapter, we focus on the Division's efforts to collect and then deploy the resources necessary to meet its objectives.

Overall, we found that the Division has not managed its resources effectively to meet its objectives. Specifically, a fundamental disparity has existed between the Division's revenues and expenses since its inception in July 2010. The Division received a large influx of revenue (about \$8.1 million) in July and August 2010, which was the result of the provision in House Bill 10-1284 that required existing medical marijuana businesses to apply for a state license by August 1, 2010, if they wanted to continue operating. Since then, the Division's monthly revenues and expenditures have rarely matched, resulting in significant revenue shortfalls or surpluses for extended periods. For example, as the chart depicting the Division's monthly net income on the next page shows, the Division experienced 19 consecutive months beginning in September 2010 in which its expenses exceeded its revenues, which was then immediately followed by 9 consecutive months (as of December 2012) in which its revenues exceeded its expenses, in both cases often by significant amounts. For example, the Division experienced a monthly net loss of about \$2.3 million in June 2011, which resulted from the Division making many large capital purchases, such as furniture, computer equipment, and software for a marijuana plant tracking system. Conversely, the Division experienced monthly net surpluses of more than \$500,000 from April to July 2012 when it began charging businesses license fees.

**Medical Marijuana License Cash Fund
Monthly Net Revenue
September 2010 Through December 2012**



Source: Office of the State Auditor's analysis of data from the Colorado Financial Reporting System.

The gaps in monthly revenues and expenses have disrupted the Division's efforts to effectively manage its resources and fulfill its regulatory duties. Specifically, the 19 consecutive months of revenue shortfalls in Fiscal Years 2011 and 2012 reduced the Division's cash fund balance to about \$740,000 in March 2012, which represented less than 2 months of the Division's expenses at the time. As a result, the Division laid off a majority of its staff by the end of Fiscal Year 2012 which caused it to curtail or cease its monitoring and auditing of medical marijuana businesses. The subsequent 9 months of revenue surpluses increased the Division's cash fund balance to \$3.5 million as of December 2012, which represents about 20 months of the Division's current expenses. Even so, the Division has not reinstated any of these regulatory activities. According to Department of Revenue (Revenue) management, the Division's reluctance to expand its operations reflects a conservative approach to spending that the Division has adopted because of the difficulty in predicting how large the medical marijuana industry will eventually be.

We acknowledge that the uncertainty of the medical marijuana industry hinders the Division's management efforts, but our audit work identified opportunities for the Division to mitigate this uncertainty through improved processes in areas such as (1) fee-setting, (2) controls over expenses, (3) performance management, and (4) strategic planning. The recommendations we make in this chapter should help the Division better define the activities and resources needed to effectively regulate medical marijuana businesses. These recommendations may also be useful as Revenue works to establish a regulatory scheme for recreational marijuana, as required by the passage of Amendment 64.

Fee-Setting

In general, a government fee should be set at a level that is related to the cost of providing the government service being supported by the fee. Setting fees this way ensures that government entities cover the costs of providing their services without overcharging those subject to the fees. As discussed, the Division is cash-funded primarily through medical marijuana business licensing and application fees. According to statute [Section 12-43.3-103(1)(b), C.R.S.], these fees are intended to pay for the direct and indirect costs of the Division's activities. The Division charges two main types of fees: (1) application fees to cover the processing of initial license applications and (2) license fees to cover ongoing monitoring of licensees and enforcement actions. The chart below shows the application and licensing fees charged by the Division during Fiscal Year 2013.

Medical Marijuana Enforcement Division Fees Fiscal Year 2013		
Category	Application Fee	License Fee
Dispensary License		
Type 1 (1-300 Patients)	\$7,500	\$3,750
Type 2 (301-500 Patients)	\$12,500	\$8,750
Type 3 (501 or more Patients)	\$18,000	\$14,000
Grow Operation License	\$1,250	\$2,750
Medical Marijuana-Infused Products Manufacturer	\$1,250	\$2,750
Key Occupational License	\$250	N/A
Support Occupational License	\$75	N/A
Vendor Registrations	\$250	N/A
Source: Office of the State Auditor's analysis of data provided by the Medical Marijuana Enforcement Division.		

We found that fees in the nine other states that license medical marijuana businesses range from \$50 to \$30,000. Comparing these fees is difficult, however, because of the differing regulatory models used in these states. The Division also charges other administrative fees, such as \$2,500 for a change of ownership and \$150 for a change in location.

We analyzed the revenues, expenses, and year-end balances for the Division's Medical Marijuana License Cash Fund (cash fund) as well as the Division's fee rate policies, procedures, and analyses from Fiscal Year 2011 to present to determine whether the Division has set its application and license fees appropriately. Overall, we found that the Division has not developed a systematic process for setting its fees at levels that correspond to the costs of providing its services. Such a process would have (1) defined the work activities to be paid for by each fee charged, (2) calculated the direct and indirect costs of performing these activities, and (3) set each fee to recover these costs. As we describe below, the Division's processes for each of these steps has been inadequate.

Defining work activities. We found that the Division has never defined the work activities that its application and license fees are supposed to support. In other words, when the Division collects application and license fees, it is not clear what work by staff these fees are supposed to pay for. For example, as mentioned before, in July and August 2010, the Division collected about \$8.1 million in application fees from medical marijuana businesses. This large influx of fee revenue resulted from a provision in House Bill 10-1284 that required existing medical marijuana businesses to apply for a state license by August 1, 2010, to continue operating. House Bill 10-1284 also established a moratorium on new license applications beginning on August 1, 2010, that would eventually last until June 30, 2012. As a result, the Division would have presumably used the \$8.1 million to process the approximately 2,400 applications received by August 2010 and not for other activities. However, as of October 2012, about 960 (41 percent) of these approximately 2,400 applications were still in "pending" status with the

Division even though the Division spent about \$11 million on its operations from July 2010 to December 2012. This disparity suggests that the Division did not use the \$8.1 million in application fees received by August 2010 solely for processing applications. Revenue management reported that some of the \$8.1 million would have been used for start-up costs for the Division but could not provide documentation to show the amount spent for this purpose. We noted that the fiscal note for House Bill 10-1284 budgeted about \$536,000 in Fiscal Year 2011 and about \$105,000 in Fiscal Year 2012 for “Operating Expenses and Capital Outlay” to be paid out of fee revenue.

Conversely, it appears that the Division began performing activities that would be supported by a license fee before it began collecting license fees. For example, the Division began inspecting dispensaries in February 2011 to verify that the dispensaries were complying with the regulatory mandate to grow at least 70 percent of the medical marijuana they sell. As we discussed in Chapter 2, on-site inspections of medical marijuana businesses are not clearly part of the application process and, therefore, may be more appropriately paid for with licensing fees. However, the Division did not start collecting license fees until April 2012, meaning that these inspections would have been paid out of application fee revenue. The Department reported to the Joint Budget Committee in January 2013 that there were \$4.8 million in outstanding license fees when it started collecting them.

Finally, the Division has not always collected fees for work its staff performs. Specifically, statute [Section 12-43.3-501(3), C.R.S.] requires the Division to set several licensing, application, and administrative fees. We found that the Division has not established a license renewal fee even though it is currently processing renewal applications. The Division also did not establish required change of ownership or change of location fees until August 2011, even though staff began processing these changes before then.

Calculating costs. We found that the Division has not consistently calculated the full cost of performing the duties related to the application and licensing processes supported by its fees and that the analysis performed by the Division has inaccurate assumptions. For example, the Division could not provide documentation of the cost analysis used to set its fees when the Division began operations in Fiscal Year 2011. The fiscal note for House Bill 10-1284, which granted the Division the authority to charge fees, provided estimates of the fee amounts. However, the actual fee amounts charged by the Division are significantly higher than these estimates, and the Division was unable to explain the difference.

Further, we found that Fiscal Year 2012 was the only year that the Division performed analysis to determine how much it costs for staff to process applications or to complete monitoring activities like on-site inspections. In other words, the Division did not perform this type of cost analysis in Fiscal Years 2011

or 2013 or for the Fiscal Year 2014 budget cycle. Additionally, we reviewed the Division's Fiscal Year 2012 analysis and identified several weaknesses in its approach. Specifically, the analysis:

- Did not incorporate data related to application fees or license renewal fees for medical marijuana businesses or license fees for medical marijuana-infused products manufacturers.
- Appeared to underestimate the amount of time needed to complete the Division's work. The table below shows the differences between the time estimates used by the Division in its Fiscal Year 2012 fee analysis versus the amount of time staff reported to us during the audit for processing certain applications.

Medical Marijuana Enforcement Division Comparison of Application Processing Time Estimates		
Application Type	Estimate from Division Fee Analysis	Estimate from Staff Survey
Dispensary	4.25 hours	15.4 hours
Grow Operation	1.5 hours	14.4 hours
Occupational Licenses	2 hours	5.75 hours
Source: Office of the State Auditor's analysis of data provided by the Medical Marijuana Enforcement Division.		

- Used inaccurate "personal services" cost and year-end cash fund balance figures to calculate its revenue needs. For personal services, the fee analysis assumed that staff salary and benefits costs for Fiscal Year 2012 would be about \$4.2 million. In addition, using the time estimates discussed in the above bullet, the Division calculated that it needed about 15 full-time equivalent (FTE) staff to perform its work in Fiscal Year 2012. Dividing these two figures (\$4.2 million/15 FTE) results in salary and benefit costs of \$280,000 per staff person. However, we found the Division's actual per-staff salary and benefit costs were much lower than \$280,000 and appeared reasonable.

For the year-end cash fund balance, the fee analysis assumed that the Division's Fiscal Year 2011 year-end cash fund balance would be about \$2.9 million, when the actual figure was about \$3.9 million.

The main reason that the Division has been unable to accurately calculate the costs associated with its licensing and monitoring activities is that it does not know how long staff spend on these activities. For example, the Division does not have a time-tracking system that captures the amount of time staff spend on various Division functions. Further, we surveyed staff and found that 5

(42 percent) of 12 respondents could not estimate how much time they spend on various work activities.

Setting fees to recover costs. Even when the Division has attempted to identify the costs that are associated with its various activities, it has not used this information to set its fees accordingly. For example, the Division's Fiscal Year 2012 fee analysis estimated that staff spend more time processing occupational license applications (2 hours) than for grow operation license applications (1.5 hours), suggesting that the fee for occupational licenses should be higher than the one for grow operation license applications. However, the grow operation license application fee (\$1,250) is significantly higher than the occupational license application fee (\$75-\$250, depending on type). Similarly, the Division's fee analysis did not distinguish between different types of dispensary licenses when estimating staff time needed to process these applications. This lack of delineation suggests that these applications take the same amount of time to process and incur similar costs regardless of type and, therefore, should command similar fees. Even so, the Division's dispensary application fees range from \$7,500 to \$18,000.

Without implementing processes to define the work activities that will be supported by each of its fees, calculating the costs of those activities, and setting fees based on those calculations, the Division cannot ensure that its revenues and expenses are in sync and that its cash fund balance is neither too high nor too low.

Recommendation No. 7:

The Department of Revenue should improve the Medical Marijuana Enforcement Division's (the Division) fee-setting by:

- a. Determining the specific licensing and monitoring activities that will be supported by each fee it charges.
- b. Establishing an ongoing systematic mechanism for collecting and analyzing data on the amount of time it takes to complete each of the licensing and monitoring activities identified in part "a" and on the associated costs of completing these activities.
- c. Using the analysis completed in part "b" as the basis for setting the Division's fees annually.
- d. Establishing an annual target reserve amount for the Medical Marijuana License Cash Fund.

Department of Revenue Response:

Agree. Implementation date: June 2014.

- a. Depending upon the statutory provisions adopted to implement Amendment 64, the Department intends to establish fees to support the regulatory and enforcement activities of the new Marijuana Enforcement Division.
- b. At this time, the Department does not have an automated time management system by which to track and report time spent on specific activities and the associated costs. The Department is exploring such a system for future implementation Department-wide. In the short term, the Department will consider performing time management studies once licensing and monitoring processes and procedures are in place after the implementation of Amendment 64 legislation.
- c. The Department intends to use the data compiled from time management studies to establish fees to fully cover the direct and indirect costs of the new Marijuana Enforcement Division's regulatory and enforcement activities.
- d. The Amendment 64 Task Force made a recommendation to fund the new Marijuana Enforcement Division with General Fund for the first five years. If this recommendation is included in the enabling legislation, any funds unspent at the end of each fiscal year will revert to the General Fund. However, at the time when the new Division becomes fully supported by cash funds, the Department would plan to establish a reserve requirement similar to other cash funds.

Expenses

The Division is responsible for ensuring that its expenses comply with State Fiscal Rules, which require that expenses be (1) reasonable and necessary, (2) supported by documentation, and (3) properly approved. We reviewed a non-statistical, judgmental sample of 70 expenses totaling about \$1.2 million incurred in Fiscal Years 2011 and 2012 to determine if the Division complied with State Fiscal Rules. We chose a judgmental sample because the Division began operating at the beginning of Fiscal Year 2011 and, therefore, made a number of large capital purchases (e.g., furniture, computers, and vehicles) to furnish its offices and equip its staff during the review period. We determined that these capital purchases represented higher risks for noncompliance because of their

amount and the need for the Division to get its operations going quickly, and we wanted to ensure that some of these expenses were included in our testing.

We identified several weaknesses with the Division's controls over its expenses including (1) a significant percentage of expenses that were not reasonable and appropriate or properly approved, (2) capital purchases that were not well-planned, and (3) vehicle expenses that were not justified. We discuss these issues in the following two sections with the first section focusing on the Division's overall controls over expenses and the second section centering specifically on the Division's vehicle expenses.

Controls Over Expenses

Our testing of the Division's expenses found problems with the Division's general controls over expenses as well as with some of the capital expenses incurred by the Division. We discuss specific issues we identified below. The first two issues involve furniture and cell phone/tablet computer purchases. Examples of both types of purchases were included in our sample of 70 expenses. The final two issues discuss our overall concerns with the reasonableness of the Division's expenses and the Division's process for approving expenses.

Furniture. When starting operations in Fiscal Year 2011, the Division set up offices in Denver, Colorado Springs, Fort Collins, and Fruita that needed to be furnished. As a result, the Division spent about \$250,000 on furniture in Fiscal Year 2011. The furniture purchases in our sample included \$28,000 for seven desk extenders, \$16,000 for three cubicles, and \$4,200 for four office chairs. We reviewed these purchases and found that the Division did not take sufficient steps to ensure that these expenses were reasonable and appropriate. Specifically, the Division did not use a competitive bidding process to outfit its four offices and instead purchased the bulk of its furniture from Colorado Correctional Industries (CCI). We conducted a brief Internet search and found numerous examples of more affordable office furniture available. During our search, it was difficult to assess the quality of the furniture we found compared to the furniture that the Division bought from CCI. However, our results suggest that the Division could have benefited from using a competitive bidding process to purchase its furniture. The State Procurement Code generally requires agencies to use a competitive bidding process whenever making purchases of more than \$150,000.

Revenue management indicated that the Division purchased furniture from CCI because of statutory requirements. While statute (Section 17-24-111, C.R.S.) requires state agencies to purchase some items from CCI, statute also allows agencies to request a waiver from this requirement if an item of similar quality can be purchased more cheaply from another source. Revenue requested and received 14 such waivers during Fiscal Years 2011 and 2012, including two waivers for office furniture in which CCI could not provide the product at a

comparable price. For these two waivers, Revenue provided internet print-outs to CCI to support the waiver requests. Revenue's 14 waiver requests did not include asking for permission to use a competitive bidding process to buy furniture for the Division's new offices.

According to statute [Section 24-101-102(d), C.R.S.], one of the underlying purposes of the State's Procurement Code is to maximize the purchasing power of public funds in Colorado. Using a competitive bidding process would have provided more assurance that the Division's initial capital purchases, such as furniture, were as cost-effective as possible.

Cell phones and tablet computers. We found that the Division purchased cell phones and tablets that appeared to not be necessary. For example, the Division purchased approximately 50 Blackberry cell phones for staff. Division staff indicated that the cell phones are necessary for those occasions when staff are out of the office visiting medical marijuana businesses. However, the Division's peak staffing was 37 FTE, including 13 administrative staff whose primary duties would not require frequent trips outside the office. Further, we analyzed cell phone records from Fiscal Year 2012 and found that, on average, 41 percent of the phones were not being used but still incurred a monthly fee. We estimated that the unused cell phones cost the Division about \$840 per month, or about \$10,000 per year.

The Division also spent about \$31,000 in Fiscal Year 2012 on 21 tablet computers for its investigative staff to use in documenting their work. At its peak staffing levels, the Division had 19 investigators but currently only has 10. The Division indicated that the excess tablets are being retained in inventory for new staff that could be hired in Fiscal Years 2013 or 2014. However, it is not clear if the Division has an ongoing business need for the tablets.

According to Division staff, purchases such as these were based on the assumption that the Division's staffing would eventually reach about 55 FTE. However, as we discuss later in this chapter, the Division could not provide the basis for this figure.

Reasonableness. Overall, we found that 17 (24 percent) of the 70 transactions tested did not appear reasonable. In addition to the above examples related to furniture, cell phones, and tablets, other examples of unreasonable expenditures included purchasing a 5-day car rental for staff attending a conference when the conference only lasted 2 days and three sets of patio furniture costing about \$1,800 without a clear business need for them. We found examples of unreasonable expenditures in both Fiscal Year 2011 (10 cases) and Fiscal Year 2012 (seven cases).

Approvals. We found that 8 (11 percent) of the 70 transactions tested were not properly approved, including examples from both Fiscal Year 2011 (three cases) and Fiscal Year 2012 (five cases).

The Division is responsible for spending public funds responsibly. Weak controls over expenses increase the risk of overspending and damage public confidence in government. These weaknesses are concerning given the volatility of the industry it regulates and the financial difficulties it has experienced.

Recommendation No. 8:

The Department of Revenue should improve the Medical Marijuana Enforcement Division's (the Division) controls over its expenses by:

- a. Conducting price comparisons and requesting a waiver to use a competitive bidding process when appropriate and warranted.
- b. Conducting a thorough analysis of the Division's current and future equipment needs and eliminating any excess equipment if it is cost-effective to do so.
- c. Ensuring that all expenses comply with State Fiscal Rules related to the reasonability, appropriateness, and approval of the expenses.

Department of Revenue Response:

- a. Agree. Implementation date: June 2013.

The Department followed all appropriate procurement statutes, codes, and rules when purchasing furniture and equipment. The Department utilized Colorado Correctional Industries (CCI) to purchase furniture per Section 17-24-111, C.R.S., which requires the Department to purchase office furniture and office systems from CCI. The Department will conduct price comparisons and request waivers to use a competitive bidding process when appropriate and warranted.

- b. Agree. Implementation date: October 2013.

The Division will continue to closely monitor its existing furniture and equipment inventory, ensuring the safeguarding of all of the Division's assets. On a semi-annual basis, the Division will review the status of active personnel in relation to its furniture and equipment inventory, and will determine whether any items should be subject to the Department's surplus procedure.

- c. Agree. Implementation date: June 2013.

The Department of Revenue (DOR) Accounting and Financial Services (AFS) will review the Department Procurement Card Policy to ensure compliance with the State Fiscal Rules and communicate to cardholders, reviewers and Division Liaisons any changes. AFS currently has processes in place to review cardholder statements on a monthly basis and will strengthen the review of these transactions. AFS will meet with departmental budget and accounting staff to review internal travel procedures to ensure knowledge and compliance with State Fiscal Rules. AFS will review the travel computer-based training to ensure travelers are knowledgeable of DOR travel policies and State Fiscal Rules.

Use of State Vehicles

The Division leases vehicles from State Fleet Management at the Department of Personnel & Administration (DPA). At its peak in Fiscal Year 2012, the Division's fleet totaled 33 vehicles, which included 21 sport utility vehicles (SUVs), 11 sedans, and 1 truck. The Division downsized its fleet in response to its financial difficulties discussed at the beginning of this chapter so that, as of December 2012, its fleet consisted of six SUVs and two sedans. The Division has assigned one of the eight vehicles to its office in Grand Junction, two to its office in Colorado Springs, and the remaining five vehicles to its office in Denver.

Since it began operations in July 2010, the Division has assigned some of its vehicles exclusively to individual employees. Specifically, the Division has required a total of six employees to commute to and from work in state vehicles, with three employees having this arrangement currently. Statute (Section 24-30-1113, C.R.S.) permits executive directors to require state employees' use of state vehicles for commuting if the commuting (1) is needed to promote a legitimate interest of the State and (2) represents a cost-effective means of doing business. DPA regulations provide examples of the types of employees that may need to commute in state vehicles, such as peace officers or employees who are on call to respond to emergency situations. However, DPA regulations also clearly state that "the mere fact that an employee performs a job function covered under one of [these job] categories outlined above does not mean that the employee should be required or approved to commute."

We reviewed the Division's use of its fleet vehicles to determine whether the Division's vehicle lease expenses and use of commuting authorizations were reasonable and appropriate. Overall, we found that the Division may have (1) leased vehicles that were not necessary, (2) authorized commuting arrangements that were not in the best interest of the State, and (3) improperly

categorized commuting arrangements as tax-exempt benefits to employees. We discuss these issues below.

Fleet size. It is not clear that the Division can justify the size and composition of its vehicle fleet. As mentioned, the Division's fleet peaked at 33 vehicles in Fiscal Year 2012. At that time, the Division had 37 FTE, including 13 administrative staff, meaning that the Division had nearly one vehicle per employee. We reviewed vehicle odometer logs from Fiscal Year 2012 and found that each month, between four and 10 vehicles were driven less than 50 miles each, suggesting that the Division could have downsized its fleet without compromising staff's ability to use fleet vehicles when necessary.

Currently, the Division has eight vehicles and 15 FTE, including the director, ten investigators, and four administrative staff. We reviewed vehicle odometer logs for Fiscal Year 2013 through December 2012 and found that on average, the vehicles were driven about 1,000 miles each month. However, for the three commuter vehicles this includes the miles driven between work and home. According to their commuting authorization forms, these three employees have daily round-trip commutes of between 20 and 30 miles, which puts about 400 to 600 miles on each vehicle each month (assuming 20 work days each month).

We also question the types of vehicles being used by the Division. The Division's fleet has been weighted toward SUVs with the current fleet consisting of six SUVs and two sedans. The Division indicated that the SUVs were needed to transport seized marijuana plants and to travel to areas in the State requiring four-wheel-drive vehicles. It is not clear that these reasons for having SUVs are justified. As we discussed in Chapter 2, the Division now typically oversees the destruction of marijuana plants at the business site rather than transport the plants. In addition, the Division could not provide documentation demonstrating how often staff travel to areas requiring four-wheel-drive vehicles. This lack of documentation is a concern because the average fixed monthly lease cost of the Division's SUVs is \$381 per vehicle compared with \$224 per vehicle for the Division's sedans. In addition, the Division must pay a variable rate of 25.5 cents per mile for its SUVs compared with 21.1 cents per mile for its sedans.

Commuting authorizations. The Division authorized commuting arrangements for six employees without demonstrating that these arrangements were in the best interest of the State. State agencies must file a form with DPA signed by their executive director to explain why requiring an employee to commute in a state vehicle is in the best interest of the State. For two of the six commuting employees, the Division did not list a reason on the commuting form explaining why the employee should be required to commute in a state vehicle. In the other four cases, the forms stated that the individuals were to be on call 24 hours per day, seven days per week. However, the Division could not provide documentation showing occasions when these four employees were required to report to a work site outside normal business hours. As a result, we also question

the need for these four employees to commute to work in a state vehicle. The Division indicated that it removed commuting authorizations for three of the six employees as of January 2013.

In addition, two of the commuting forms were signed by Revenue's Executive Director retroactively. The retroactive forms included the authorization for one current employee, whose form was signed by the Executive Director six months after the employee began commuting and after we brought this matter to the Division's attention.

Tax exemptions. The use of state vehicles for commuting is considered to be a taxable fringe benefit under federal law, and a commuting employee must either reimburse his or her employer for the cost of the commuting or report the commuting benefit as taxable income. Law enforcement officers, however, are exempt from paying taxes on their commuting benefits. DPA's commuting authorization form requires agencies to specify whether the person being required to commute in a state vehicle is exempt from reimbursable or taxable commuting. The Division indicated for all six employees required to commute that they were exempt from reimbursable or taxable commuting because they met the IRS and Colorado statutory definitions of a peace officer.

We question whether the Division properly categorized these commuting arrangements as being exempt from reimbursement or taxation for two of the employees because it is not clear that these employees meet the state or federal definition of a peace officer. Specifically, these two commuting employees are the former and current director of the Division. Statute (Section 16-2.5-124.5, C.R.S.) defines Division investigators as peace officers, but not the Division director. If these employees do not meet the definition of a law enforcement officer, we estimate that they would each need to reimburse the Division about \$60 per month, or \$720 per year, or claim this amount as taxable income.

Recommendation No. 9:

The Department of Revenue should improve the Medical Marijuana Enforcement Division's (the Division) use of state vehicles by:

- a. Evaluating the use of the current fleet to determine whether the Division can eliminate some fleet vehicles altogether and/or weight the fleet toward more economical vehicles.
- b. Reviewing the commuting arrangements for the three staff that currently have them and discontinuing these arrangements unless the Division can demonstrate that it is in the best interest of the State for these staff to have these arrangements.

- c. Determining whether the commuting arrangements have been properly classified and reported with respect to tax treatment for employees. If commuting arrangements were improperly reported as tax-exempt benefits, the information should be reported to State Fleet Management and the State's Central Payroll. The Department should ensure that either prior years' employee income reporting to the IRS is corrected or employees reimburse the Division for all taxable commuting.
- d. Establishing controls to ensure that all future commuting arrangements are in the best interest of the State and are properly classified for tax purposes.

Department of Revenue Response:

Agree. Implementation date: June 2013.

- a. When the Division acquired its fleet vehicles in Fiscal Year 2011, it was determined that a larger SUV would allow the Division to transport marijuana plants and derivatives seized or voluntarily surrendered by licensees. Additionally, the span of coverage for regulation of medical marijuana was virtually statewide with licensees in every area of the state, including rural and mountainous areas. The Division identified a need for vehicles with 4-wheel drive to travel around the state during inclement weather, through the mountains and in rural areas. The acquisition of 33 fleet vehicles in the early stages of the Division was intended for the purpose of meeting the needs of a fully staffed Division at 55 FTE. When the Division recognized that funding shortages would require a reduction in staffing, the Division took measures to eliminate or transfer approximately 25 vehicles to other state agencies. The Division will evaluate its current fleet of eight vehicles to determine an appropriate level to meet current needs and increased needs in the very near future due to the implementation of Amendment 64. This assessment will include an evaluation of the types of vehicles that are the most appropriate for the Division based on work assignments, vehicle use and fuel efficiency.
- b. The Division will evaluate current commuting arrangements for existing staff to ensure they are appropriate. The Division will develop written policies and procedures establishing when it is appropriate to execute a commuting agreement for an employee based on established guidance, from both the state and federal level, and the business needs of the agency. The Division will also clearly document on all commuting authorization forms the purpose for commuting and how it is in the best interests of the State.

- c. The Division will consult with the Department of Personnel & Administration, Department accounting staff, and will also carefully review all existing guidelines at both the state and federal level to ensure that commuting arrangements for staff have been properly classified for the taxing purposes. Any commuting arrangements that have not been properly classified will be reported to State Fleet Management and Central Payroll and appropriate adjustments will be made.
 - d. The Division will establish written policies and procedures for determining when it is appropriate to execute a commuting agreement for an employee based on established guidance, at both the state and federal level, and the business needs of the agency. The Division will also clearly document on all commuting authorization forms the purpose for commuting and how it is in the best interests of the State.
-

Strategic Planning

The previous sections in the report on licensing, monitoring, fees, and expenses demonstrate that the Division has had difficulty implementing the medical marijuana regulatory framework envisioned by the General Assembly. As our report has shown, the Division has not:

- Processed medical marijuana business and occupational licenses timely.
- Developed a monitoring system to track the flow of medical marijuana from seed to sale, which would help prevent medical marijuana from entering from or exiting to the black market.
- Provided ongoing oversight of medical marijuana businesses currently in operation.
- Projected its expenses and revenues accurately and maintained adequate funding levels.
- Anticipated its resource needs.
- Ensured that all of its expenses are reasonable and appropriate.

Establishing a new regulatory framework requires effective planning to determine the work required for effective oversight of an industry and the funding levels needed to support that work. Revenue management indicated that it has been very difficult to effectively plan for the work and the funding of the Division because of the volatility of the medical marijuana industry. Specifically, staff said that forecasting the number of medical marijuana businesses that the Division would eventually be overseeing has been a complex task because (1) the industry was new and it was not clear how many businesses that the market would support and (2) many local jurisdictions have taken the option to ban medical marijuana

businesses in their communities even after they were already operating and subject to Division regulation.

Although we recognize the obstacles that the Division has faced in determining optimum staff and funding levels, the Division has not developed spending and staffing plans that would allow it to fully meet its statutory duties or adapt to changing conditions. For example, we reviewed the Division's strategic plan for Fiscal Year 2013 and found that the plan:

- Contained few specific goals or strategies for ensuring that the Division's licensing and monitoring activities are effective and efficient.
- Contained no goals or strategies for ensuring that its funding and staffing are adequate for effectively regulating the medical marijuana industry.
- Did not assign staff responsibility, establish deadlines, or provide work steps for completing many goals and strategies.

In addition, we asked Revenue management how the Division's budget appropriations have been determined. The Division was appropriated about \$5.7 million and 55.2 FTE in Fiscal Years 2012 and 2013, and Revenue requested these same amounts for the Division in Fiscal Year 2014. However, Revenue could not provide any documentation to demonstrate how these numbers were derived. Revenue management indicated that planning decisions for the Division are now being driven by current revenue levels, which project to about \$2.4 million annually. It is unclear, though, whether \$2.4 million annually is appropriate funding for the Division because the Division has not developed any specific budget plans for how it would spend that amount of money.

The Division needs to take a more proactive approach to planning its activities and associated funding needs by creating a better, more comprehensive strategic plan. Strategic plans help an organization to define its purpose and to effectively allocate the resources needed to meet this purpose. In the Division's case, a strategic plan would help the Division to define the work it must perform to implement the medical marijuana regulatory scheme envisioned by the General Assembly and determine the resources needed to accomplish this work.

Recommendation No. 10:

The Department of Revenue should improve the effectiveness of the Medical Marijuana Enforcement Division's oversight of medical marijuana businesses in Colorado by developing a comprehensive strategic plan that (1) identifies the licensing, monitoring, and enforcement activities required to effectively regulate these businesses and (2) determines the staffing and operational resources needed to perform these activities. The plan should consider different scenarios to account for the uncertain future of the medical marijuana industry in Colorado.

Department of Revenue Response:

Agree. Implementation date: July 2013.

The Department of Revenue is currently in the process of developing a comprehensive strategic plan, including staffing and business operations, for the regulation of marijuana (both medical and adult-use). The Amendment 64 Task Force has recommended that the General Assembly create one agency within the Department to regulate both medical and adult-use marijuana in the state. The Department is therefore proceeding with the development of a comprehensive strategic plan that encompasses a staffing plan, business operations plan, and specific objectives and goals related to both the licensing and regulation of marijuana businesses in the State of Colorado, as well as the implementation of Amendment 64. While medical marijuana and adult-use marijuana each have their own unique regulatory requirements, there are more similarities between them than there are differences. As part of this process, the Department is attempting to forecast the number of medical marijuana and adult-use marijuana licenses expected upon implementation of Amendment 64. This critical factor, along with clearly identified statutory and regulatory requirements for each business type, will assist the Department in defining key objectives and resource needs moving forward.

Performance Measurement

As discussed earlier, the SMART Government Act requires agencies to establish strategic plans with performance measures so that agencies can determine if they are meeting their objectives and allocating their resources effectively. We reviewed Revenue's strategic plan for the Fiscal Year 2014 budget cycle to determine if any performance measures had been established for the Division. We found that the Division has one performance measure, which is related to the timely processing of business license applications. As the table below shows, the Division's benchmark starting in Fiscal Year 2013 is to initiate final agency action on post-moratorium applications within 60 days of license approval by the local licensing authorities in 90 percent of cases. The table also shows that the Division does not have any prior actual data due to this being a new performance measure.

Medical Marijuana Enforcement Division Fiscal Year 2013 Performance Measure					
<i>Performance measure: Initiate final agency action¹ on license applications within 60 days of local approval.</i>					
Fiscal Year	2010	2011	2012	2013	2014
Benchmark	N/A	N/A	N/A	90%	90%
Actual	N/A	N/A	N/A	TBD	TBD
Source: Department of Revenue strategic plan for the Fiscal Year 2014 budget cycle.					
¹ Final agency action means license issued/renewed or license denied.					

In accordance with the SMART Government Act [Section 2-7-204(4), C.R.S.], we evaluated the integrity of the Division’s performance measure and the accuracy and validity of the reported results for the performance measure. To determine the integrity of the Division’s performance measure, we assessed whether the performance measure was meaningfully related to the Division’s work and whether the performance measure covered activities that the Division can impact or control. Because this is a new performance measure, we could not evaluate the accuracy and validity of past reported results. Instead, we determined whether the Division’s information system can capture the data needed to produce accurate and valid results.

Overall, we found that measuring the timeliness of the Division’s review of business licensing applications is an appropriate metric by which to evaluate the Division’s performance. However, we identified several concerns about the Division’s specific performance measure for measuring timeliness, as discussed below.

Benchmark does not necessarily capture applicant’s overall wait time. The performance measure evaluates timeliness from the point that the local licensing authority issues a license and not from the point the applicant submits an application to the Division. As a result, the benchmark does not capture the applicant’s overall time waiting for the Division to process the application. For example, in our review of five randomly selected post-moratorium application files, the applications had been pending at the Division for an average of 99 days, during which time the Division had begun to work on at least one of the files. However, with no evidence that the local licensing authority had approved a license in any of these five cases, the Division’s clock would not yet have started for measuring performance against this 60-day timeliness benchmark. As a result, the Division may report success in meeting the 60-day processing benchmark for a given file, even if the overall experience of the applicant was to wait far longer than 60 days before receiving a license or a denial from the Division.

Vague terminology makes the end point for measuring performance unclear. Statute [Section 2-7-202(11), C.R.S.] states that performance measures “should be reasonably understandable to the public.” It is unclear what it means for the Division to “initiate” a final agency action. For example, it is not certain if this

term means that the Division will issue a final decision (i.e., approve or deny) on the application, start the application evaluation process, or something in between. The vagueness of the term “initiate” could allow the Division to count a given file successful in meeting the 60-day benchmark if the Division had started its file review but had not yet issued a license or denied an application.

Key data points needed to measure performance are not captured. The Division’s My License Office (MyLO) does not capture the date the local license was approved, which is the starting point for the 60-day performance measure as currently written. In addition, MyLO does not capture the name of the local licensing authority, the status of the local license, or whether concurrent review was requested—all of which are relevant data for the Division to monitor its performance. The lack of system data raises concerns about the Division’s ability to provide reliable data for this performance measure and effectively monitor performance to identify where improvements are needed. The Division indicated that this information is being captured on a spreadsheet maintained outside MyLO. However, at the time of the audit, this spreadsheet did not capture the date of local license approval, the name of the local licensing authority, or a record of contacts with the local authority.

Overall, the Division’s performance measure does not appear to align well with the Division’s actual practices. Specifically, the performance measure assumes that the local licensing process is wholly separate from the Division’s licensing process. However, as noted above, the Division may perform at least part of its application review while the local licensing authority is also reviewing the application.

Recommendation No. 11:

The Department of Revenue should improve its method for assessing the Medical Marijuana Enforcement Division’s (the Division) performance by:

- a. Aligning the performance measure with the Division’s actual practices to better capture the timeliness of the Division’s complete business application process.
- b. Clarifying what is meant when the Division “initiates” final agency action.
- c. Making improvements to the Division’s My License Office system to ensure that key data points related to the Division’s performance measures are captured.

Department of Revenue Response:

Agree. Implementation date: July 2013.

- a. The Department will add a performance measure(s) that measures duration from the date the application is received by the Division to the date work is completed by Division staff. We will also measure from the date work is completed by the Division to the date we receive local agency approval. We will then continue to measure from the date of local agency approval to date final action is initiated by MMED.
- b. The Department will footnote the definition of “initiate.”
- c. The Department of Revenue will work with the Office of Information Technology to identify and capture the appropriate key data points related to the Division's performance measures. We anticipate that, with the passing of Amendment 64 and changes within the medical marijuana industry itself (i.e. consolidation, competition, etc.), the data points themselves in need of tracking may change. We agree that tracking the appropriate data points, once identified, is an important step in the success of the Division.

Reporting

To effectively manage its operations, an agency needs quality data and the ability to analyze that data to monitor its performance. The Division uses the My License Office (MyLO) information system for tracking its licensees. To assess the quality and availability of the Division's data, we determined whether key data about the Division's licensing and monitoring processes are captured in MyLO and available for analysis.

We found that the Division does not capture all the key data in its MyLO system needed to effectively manage its licensing and monitoring functions. Specifically, the Division does not have the ability to run system reports in MyLO to report on key, relevant information, such as:

- The pending applications and licensed businesses within a given local licensing authority's jurisdiction.
- The applications for which concurrent review was requested by the applicant or the local licensing authority.
- The status and effective dates of local licenses.
- The number of days to complete and the outcome of background investigations.

- The number of, reason for, and outcome of on-site inspections.
- Occupational licenses associated with a specific business.
- The number of employees and patients reported by a business.
- Local jurisdictions that have banned medical marijuana establishments.

As currently programmed, the MyLO system does not capture sufficient data to allow the Division to effectively monitor its operations. As a result, the Division cannot generate reports that show the timeliness of different stages of the application process, give a high-level view of the status of all applications, or provide information about its monitoring efforts.

The Division also reported that it does not have the ability to develop and run ad hoc management reports from the MyLO system because of the way that the Office of Information Technology (OIT) has designed the permissions given to Division staff. Specifically, the MyLO server is shared with other enforcement divisions within Revenue and, to ensure that each division has access only to its own data, OIT has not given any division full permissions to mine its own data. In addition, Division staff report to have limited expertise in using the SQL Server Reporting Services reporting software currently made available to the Division by OIT.

Recommendation No. 12:

The Department of Revenue should improve the Medical Marijuana Enforcement Division's (the Division) access to management data by:

- a. Identifying and working to capture in the Division's My License Office system the data points the Division needs to effectively track and manage medical marijuana applicants and licensees.
- b. Working with the Office of Information Technology to ensure that Division staff have the access permissions and training they need to run system reports.
- c. Developing system reports to better track the status of applications and monitoring and enforcement efforts.

Department of Revenue Response:

Agree. Implementation date: July 2013.

- a. The Department of Revenue will work with the Office of Information Technology (OIT) to identify and capture the appropriate data points to effectively track and manage medical marijuana applicants and

licensees. In particular, the Department will create a “user defined” field in MyLO to capture the date of local approval for post-moratorium medical marijuana applicants and any new medical marijuana applicants for which local licensing is required.

We anticipate that, with the passing of Amendment 64 and changes within the medical marijuana industry itself (i.e. consolidation, competition, etc.), that the data points themselves in need of tracking may change.

We agree that tracking the appropriate data points, once identified, is an important step in the success of the Division.

- b. The Department of Revenue will work with the Office of Information Technology (OIT) to ensure that Division staff have the access permissions and training they need to run system reports, as needed and as developed.

MyLO does have a significant amount of reports that are in use by the Division for tracking applications and licensees already. To the extent that ad hoc reports need to be developed, OIT has recently provided the appropriate Division personnel the software needed, and those personnel are currently training on the use of the software for developing the ad hoc reports from the MyLO system. Once developed, the reports will be either made available to other users in the Division or provided to them, upon request, by the Division personnel above.

We anticipate that, with the passing of Amendment 64 and changes within the medical marijuana industry itself (i.e. consolidation, competition, etc.), that the reporting requirements within the Division may change.

We agree that developing the appropriate reports and training the appropriate individuals, once determined, is an important step in the success of the Division.

- c. The Department of Revenue will work with the Office of Information Technology (OIT) to ensure that Division staff have the access permissions and training they need to run system reports, as needed and as developed.

MyLO does have a significant amount of reports that are in use by the Division for tracking applications and licensees already. To the extent that ad hoc reports need to be developed, OIT has recently provided the appropriate Division personnel the software needed, and those

personnel are currently training on the use of the software for developing the ad hoc reports from the MyLO system. Once developed, the reports will be either made available to other users in the Division or provided to them, upon request, by the Division personnel above.

We anticipate that, with the passing of Amendment 64 and changes within the MMED Industry itself (i.e. consolidation, competition, etc.), that the reporting requirements within the Division may change.

We agree that developing the appropriate reports and training the appropriate individuals, once determined, is an important step in the success of the Division.

Compliance with Federal Marijuana Laws

Chapter 4

The State Auditor is subject to certain reporting requirements under generally accepted government auditing standards when auditors encounter potentially illegal activities. Specifically, *Government Auditing Standards* state, “Auditors should disclose significant facts relevant to the objectives of their work and known to them which, if not disclosed, could mislead knowledgeable users, misrepresent the results, or conceal significant improper or illegal practices.” Consequently, we reviewed federal laws and court rulings related to medical marijuana and documentation concerning the federal government’s enforcement of marijuana-related laws to identify potential conflicts between federal and State laws related to marijuana used for medical purposes.

Federal law prohibits marijuana use of any kind, including its use for medical purposes. Specifically, the federal Controlled Substances Act (21 USC 801) establishes that it shall be unlawful for any person to knowingly or intentionally “manufacture, distribute, or dispense, or possess with intent to manufacture, distribute, or dispense, a controlled substance.” That law classifies marijuana as a schedule 1 controlled substance, which is defined as a drug or other substance with a high potential for abuse, no currently accepted medical use in treatment in the United States, and a lack of accepted safety for use of the drug or other substance under medical supervision (21 USC 812).

Court rulings have further established the illegality of marijuana use under federal law. For example, in a 2005 decision (*Gonzales v. Raich*), the U.S. Supreme Court ruled that the federal government can criminalize any production and use of marijuana, even if states have passed laws legalizing the use of medical marijuana. The ruling cited the Supremacy Clause of the U.S. Constitution, which establishes the supremacy of federal laws over state laws, and the Commerce Clause, which establishes the federal government’s authority to regulate interstate commerce. The U.S. Supreme Court found that under these constitutional clauses, the U.S. Congress had authority to regulate medical marijuana produced in California, where the case originated, because the production of marijuana meant for home consumption affects supply and demand in the national market for marijuana.

Our review of federal law and court rulings indicates that Colorado’s legalization of marijuana for medical use violates federal law, which prohibits the use of

marijuana for any purpose. Through formal communications and criminal enforcement activities, the federal government has demonstrated that it has also concluded that state laws legalizing medical marijuana violate federal law. For example, in April 2011, a letter to Colorado's Attorney General from the U.S. Attorney for the District of Colorado stated that "the prosecution of individuals and organizations involved in the trade of any illegal drugs...is a core priority of the Department." The letter went on to say that the U.S. Justice Department maintains "the authority to enforce the CSA [Controlled Substances Act] vigorously against individuals and organizations that participate in unlawful manufacturing and distribution activity involving marijuana, even if such activities are permitted under state law."

The federal government has also targeted enforcement activities at medical marijuana businesses operating in Colorado and other states. For example, in 2011 the Obama Administration began a series of well-publicized raids of medical marijuana businesses in California. In February 2012, the U.S. Attorney began issuing a series of letters threatening legal action against Colorado medical marijuana businesses operating within 1,000 feet of schools, unless those businesses agreed to close down. The federal government reported that 48 dispensaries closed in Colorado in Calendar Year 2012 as a result of these letters. Furthermore, the Internal Revenue Service has conducted tax audits of medical marijuana businesses in Colorado and elsewhere to determine whether those entities can legally deduct business expenses from their federal taxes.

Given the conflict between federal and state laws regarding marijuana used for medical purposes, we are concerned that the state agencies that administer Colorado's medical marijuana program, the Departments of Revenue (Revenue) and Public Health and Environment (Public Health), may be conducting activities that the federal government considers illegal. As a result, the approximately 50 state employees currently involved with administering and regulating Colorado's medical marijuana system could face potential legal liability for their involvement in an industry that violates the federal Controlled Substances Act. Colorado's Attorney General acknowledged these potential risks in an April 2011 letter to the Governor and members of the General Assembly. The Attorney General's letter stated that "of great concern is the fact that...U.S. Attorneys do not consider state employees who conduct activities under state medical marijuana laws to be immune from liability under federal law."

The U.S. Department of Justice has issued several formal communications conveying the federal government's position on enforcing federal laws against employees involved with state medical marijuana programs. For example, an April 2011 letter from the U.S. Department of Justice to the State of Washington stated that employees involved with regulating Washington's medical marijuana system "would not be immune from liability" under the Controlled Substances Act. Further, in June 2011 the U.S. Department of Justice issued a memorandum to U.S. Attorneys stating that "persons who are in the business of cultivating,

selling or distributing marijuana, *and those who knowingly facilitate such activities* [emphasis added], are in violation of the Controlled Substances Act, regardless of state law.” The memorandum went on to say that “state laws or local ordinances are not a defense to civil or criminal enforcement of federal law with respect to such conduct, including enforcement of the CSA [Controlled Substances Act].”

Revenue and Public Health should take additional steps to clarify the potential legal liability that they, as well as their employees, face because of their involvement in an industry that federal law considers unlawful. Revenue reported that Division management informally discussed the conflict between state and federal law with staff in April 2011. Specifically, management advised employees that while the Division was operating pursuant to state law, the Division could not predict what action the federal government might take to enforce federal laws prohibiting medical marijuana. However, as of December 2012, Revenue had not sought formal or informal clarification from the federal government regarding the potential legal liability of state employees involved with administering and enforcing Colorado’s medical marijuana system. Similarly, Public Health staff reported being unaware of any actions, or associated risks, that may be initiated by the federal government toward the agency and/or its employees.

State employees who become involved with regulating Colorado’s emerging recreational marijuana industry may face similar risks. Following the November 2012 passage of Amendment 64, which legalized the sale and consumption of marijuana for recreational purposes, Colorado’s Governor and Attorney General sought guidance from the federal government about those risks. In a November 2012 letter, they requested clarification about whether the federal government will regard state employees “who regulate and oversee the growing and distribution of marijuana as acting in violation of federal law.” As of March 2013, the federal government was still evaluating this issue.

Recommendation No. 13:

The Department of Revenue and the Department of Public Health and Environment should work with the Governor’s Office and the Attorney General to seek clarification from the federal government about potential risks to state employees involved with administering and regulating Colorado’s medical marijuana system and should then communicate this information to their state employees working in the medical marijuana system.

Department of Revenue Response:

Agree. Implementation date: July 2013.

On November 13, 2012, Governor Hickenlooper and State Attorney General Suthers sent a joint letter to Eric Holder, United States Attorney General. The primary focus of this letter was to seek clarity from the U.S. Department of Justice on their position concerning the passage of Amendment 64 by the people of Colorado. The letter specifically asked if “the federal government will take legal action to block implementation of Amendment 64, or whether it will seek to prosecute grow and retail operations.” This letter also sought clarification from the U.S. Department of Justice as to “whether the federal government will regard Colorado State employees who regulate and oversee the growing and distribution of marijuana as acting in violation of federal law.” This question directly goes to the heart of the recommendation. Recently, at the end of February, Attorney General Holder indicated publicly that the U.S. Department of Justice is in the process of reviewing both the Colorado and Washington initiatives. He further indicated that the people of Colorado and Washington state deserve an answer concerning the federal government’s position and that an answer would be forthcoming “relatively soon.” Once we receive guidance from the federal government, this information will be shared with all employees involved in the regulation of marijuana with the Department of Revenue.

Department of Public Health and Environment Response:

Agree. Implementation date: June 2013.

The Department of Public Health and Environment (Department) agrees to work with the Governor’s Office and the State Attorney General’s (AG) office to determine how to best obtain clarification concerning the risk of federal prosecution for state employees who administer the Medical Marijuana program. The Department has worked closely with the AG’s office on multiple legal issues concerning the implementation and administration of the medical marijuana registry, and continues to work with the AG’s office on issues related to medical marijuana as they arise. The United States Attorney for the District of Colorado sent the Colorado Attorney General a letter dated April 26, 2011, in which the United States Attorney General for the District of Colorado identified several ongoing or proposed activities related to medical marijuana that were considered to be in violation of federal law. No reference is made in this letter to state employees administering the registry as being in violation of federal law. The results of the Department’s inquiry to the federal government will be

shared with our employees who administer the Medical Marijuana program.

This page intentionally left blank.

Appendix

This page intentionally left blank.

Appendix A

Summary of Findings Related to the SMART Government Act Medical Marijuana Regulatory System, Part I Medical Marijuana Enforcement Division Department of Revenue March 2013

The SMART Government Act [Section 2-7-204(4), C.R.S.] requires the State Auditor to annually conduct performance audits of one or more specific programs or services in at least two departments so as to audit all departments in a 9-year cycle. These audits may include, but are not limited to, the review of:

- The integrity of the department's performance measures included in its strategic plan.
- The accuracy and validity of the department's reported results.
- The overall cost and effectiveness of the audited programs or services in achieving legislative intent and the department's goals.

The performance audit relating to Colorado's medical marijuana system was selected for focused audit work related to the SMART Government Act. This document outlines our findings related to the integrity and reliability of performance measurement for the Department of Revenue's Medical Marijuana Enforcement Division (the Division) and the Division's overall effectiveness. We have presented our findings as responses to six key questions that can assist legislators and the general public in assessing the value received for the public funds spent at the Division.

What is the purpose of this program/service?

The Medical Marijuana Enforcement Division is responsible for licensing and regulating medical marijuana businesses.

What are the costs to the taxpayer for this program/service?

In Fiscal Year 2012, medical marijuana businesses paid about \$3.8 million in fees to the Division. Division expenditures in Fiscal Year 2012 were about \$5.2 million.

How does the Department measure the performance of this program/service?

The Department of Revenue's Fiscal Year 2014 SMART Government Act strategic plan includes one performance measure related to the Medical Marijuana Enforcement Division, as outlined in the following table.

Medical Marijuana Enforcement Division Fiscal Year 2013 Performance Measure					
<i>Performance measure: Initiate final agency action¹ on license applications within 60 days of local approval.</i>					
Fiscal Year	2010	2011	2012	2013	2014
Benchmark	N/A	N/A	N/A	90%	90%
Actual	N/A	N/A	N/A	TBD	TBD
Source: Department of Revenue strategic plan for the Fiscal Year 2014 budget cycle.					
¹ Final agency action means licensed issued/renewed or license denied.					

Is the Department’s approach to performance measurement for this program/service meaningful?

As discussed in Chapter 3 of the report, we found that the Medical Marijuana Enforcement Division’s performance measure does not appear to align well with the Division’s actual practices. Specifically, the performance measure assumes that the local licensing process is wholly separate from the Division’s licensing process. However, the Division may perform at least part of its application review while the local licensing authority is also reviewing the application. Therefore, it would be more meaningful for the Division to measure timeliness of its review process from the date it receives the business’s application to the date that the Division issues a license or denies an application. Additionally, it is unclear what is meant by “initiate” final agency action and therefore what the time frame for performance is. Recommendation No. 11 of the report addresses these issues.

Are the data used to measure performance for this program/service reliable?

As discussed in Chapter 3 of the report, we found that the Division does not capture key data points needed to measure performance against this benchmark in its information system. Specifically, the Division’s information system does not capture the date the local license was approved, which is the starting point for the 60-day goal as currently written. Recommendation No. 12 of the report addresses this issue.

Is this program/service effective in achieving legislative intent and the Department’s goals?

This audit raised concerns about the Medical Marijuana Enforcement Division’s effectiveness in achieving legislative intent for regulating medical marijuana businesses. Included throughout the report are recommendations to improve processes for licensing and monitoring businesses, setting fees, and developing an overall strategic plan for the Division.

The electronic version of this report is available on the website of the
Office of the State Auditor
www.state.co.us/auditor

A bound report may be obtained by calling the
Office of the State Auditor
303.869.2800

Please refer to the Report Control Number below when requesting this report.

Report Control Number 2194A

Report Control Number 2194A