

**Independent Review of the  
Empire State Film Production  
and Post Production Credit  
Programs**

**New York State  
Urban Development Corporation**

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March 2015

TOSKI & CO., P.C.  
CERTIFIED PUBLIC ACCOUNTANTS

March 2015

Ms. Kathleen Mize  
Deputy Chief Financial Officer and Controller  
Empire State Development Corporation  
633 Third Avenue  
New York, NY 10017

We have performed an independent review of the Empire State Film Production and Post Production Credit Programs, pursuant to Section 6 of Part B of Chapter 59 of the Laws of 2013. As detailed in this legislation, we have been retained to conduct an independent review to assess the following:

- The efficiency of ESD's operations with regard to processing Film and Post Production Initial and Final Applications;
- The accuracy of Tax Credits granted by ESD;
- The reliability of ESD's financial tracking of application data and tax credit amounts issued;
- Adherence to, and compliance with, laws and regulations promulgated for the Programs.

The procedures performed are detailed in the accompanying report, but generally consisted of a review of the Initial and Final Applications for the Tax Credits, supporting documentation, Program policies and procedures, and legal requirements of the Program. Our procedures also included interviews with relevant Program personnel. We were not engaged to, and did not, conduct an audit, the objective of which would be the expression of an opinion on the accounting records. Accordingly, we do not express such an opinion. Had we performed additional procedures, other matters might have come to our attention that would have been reported to you.

This report is intended solely for the information and use by ESD for distribution as required by statute, and is not intended to be, and should not be used by anyone other than ESD and the intended recipients, without their consent.

Sincerely,

Toski & Co., CPAs, P.C.

Toski & Co., P.C.

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## **BACKGROUND**

The New York State Film Tax Credit Program is designed to increase the film and television production and post-production industry presence in New York State, and to provide an overall positive impact to the State's economy. The Program provides tax credit incentives to qualified production companies that produce feature films, television series, television pilots and films for television, and/or incur post-production costs associated with these productions.

The Empire State Film Production Credit was first enacted in 2004 (Chapter 60) and was subsequently amended several times to either increase and extend program funding or to increase the amount of credit for a project (e.g. 10% to 30% of qualified costs). In 2010, the Empire State Post Production Tax Credit was enacted. Total funding authorized as the first pool of program funds is \$1.035 billion for tax years 2004 to 2013. An additional pool of \$3.78 billion of funds were authorized for tax years 2010 through 2019 (\$420 million/year). The Post Production Tax Credit is financed out of this additional pool and the amount of funds dedicated to Post Production projects were increased from \$7 million/year for the period 2010 – 2014 to \$25 million/year for the period 2015 – 2019. Finally, beginning in 2015, film companies are eligible for an additional 10% credit for labor costs incurred in certain upstate counties.

## **ENGAGEMENT OBJECTIVE AND SCOPE**

Toski & Co., P.C. ("Toski") was engaged to perform an independent review of the Empire State Development's ("ESD") Empire State Film Production and Post Production Credit Program ("Program") and provide a report detailing the results of this review. Included in the report must be an assessment of each component of the Program with respect to the following areas:

- Efficiency of ESD's operations with regard to processing the Empire State Film Production and Post Production Credit initial and final applications
- Accuracy of tax credits granted by ESD (representing the distribution of assets and funds) following its application reviews
- Reliability of ESD's financial tracking of application data and tax credit amounts issued
- Adherence to, and compliance with, laws and regulations promulgated for the program, specifically regarding matters including, but not limited to:
  - Applicants eligible for the program
  - Applicants' applications clearly reflect only those costs specifically deemed eligible under program guidelines and regulations, and clearly and specifically excludes costs not eligible for the program
  - Applicants' projects in the program are not of a nature that would render such project, or portions thereof, ineligible for the tax credit provided

The scope of this engagement included a review of Program activities for the period January 1, 2013 through December 31, 2014.

## **INFORMATION OBTAINED AND INDIVIDUALS INTERVIEWED**

In performing our review, we examined the following information:

- New York State Film Tax Credit Guidelines and related Appendix A – Empire State Development website.
- Empire State Development Film Tax Credit Program – Application Process
- Empire State Development Film Tax Credit Program – Application Materials
- Sample Application Documents:
  - Initial Application – Template
  - Final Application – Template
  - Budget Cost Qualifier – Template
  - Employment Report – Template
  - End Credit Requirements – Template
- Shoot Days Summary – Template
- Schedule of Qualified Expenditures – Film Production/Post Production
- Summary Tax Credits Issued by Year – Production/Post Productions
- Summary Tax Credit Projections by Year – Production/Post Production
- Film Tax Credit Quarterly Reports – Q1 2013 – Q3 2014
- Detail of Tax Credits Issued – 2013/2014 – Production/Post Production.
- Detail of Applications:
  - Production – Initial Submitted – 2013-2014
  - Production – Initial Received/No Final Received
  - Production – Final Received – Qualified – Credits Issued
  - Production – Final Received/Pending Review – No Credit Issued Yet
  - Post Production – Initial Received/No Final Received
  - Post Production – Final Received – Qualified – Credits Issued
  - Post Production – Final Received/Pending Review – No Credit Issued Yet
- Audit Review Procedures Memo
- Program Director Job Description
- Senior Auditor Job Description
- Third Party Verification CPA Workshop Presentation
- CPA Finalized Agreed Upon Procedures (AUP) – Third Party Verification
- CPA Inspection AUP Checklist
- Final Applications and Supporting Documents for Selected Projects Issued Tax Credits During 2013 – 2014

We also interviewed the following ESD personnel:

- Randy Coburn – Senior VP of Economic Incentives
- Constance McFeeley – Program Director
- Greg Mailman – Senior Program Manager
- John Yerina – Senior Auditor
- Heidi Pasos – Economic Development Program Specialist 1

## **PROCEDURES PERFORMED**

The procedures performed by Toski over the course of this engagement include:

- 1.) Obtained and reviewed available documentation regarding the Tax Credit Program either through the ESD/Program website or directly through ESD personnel.
- 2.) Obtained and reviewed New York State Regulations and related statutory guidance regarding the Tax Credit Program
- 3.) Requested and received summary-level and detailed information regarding Initial and Final Applications for the Film Production and Post Production Credits for 2013-2014
- 4.) Obtained and reviewed summary-level and detailed information regarding tax credits issued for the Film Production and Post Production Credits for 2013-2014
- 5.) Selected a sample of projects issued Film Production and Post Production Credits in 2013-2014
- 6.) Obtained and reviewed procedures employed by ESD for auditing and approving Final Applications for the Tax Credit(s)
- 7.) Conducted interviews with ESD personnel engaged in the Tax Credit Program administration and audit process
- 8.) Obtain and review Agreed Upon Procedures and related guidance for CPA Inspection Agreed Upon Procedures initiative
- 9.) Perform detailed review of sample of projects based on ESD eligibility and audit guidelines to determine:
  - a. Eligibility verified
  - b. Consistent application of ESD procedures
  - c. Reconciliation of significant general ledger accounts
  - d. Sufficiency of ESD procedures applied
  - e. General accuracy of ESD procedures

Comments, observations and recommendations based on the results of the procedures performed have been included in this report in the section titled "Observations and Recommendations".

## **PROGRAM ASSESSMENT**

As previously noted, the objective of this engagement was to provide an assessment of each program component in several areas. Based on the procedures performed, our assessment is as follows:

### **Film Production Credit**

#### *Efficiency of ESD Operations*

The Initial and Final Application processes are appropriately designed and should be effective and efficient. However, a significant backlog of Final Applications awaiting audit and approval exists for the Film Production component. The issue facing the Program over the period of review related to the volume of Applications that had been received. It is likely that the backlog will be reduced through the incorporation of the AUP program with qualified CPA firms. In addition, ESD has increased Program staff to further reduce the backlog. However, it is our recommendation that the Program create a formalized training program to assist in the expeditious and effective training of incoming personnel.

#### *Accuracy of Tax Credits Issued*

Generally speaking, through our review of the Final Applications and related documents provided, it appears that the distribution of program assets and funds, in the form of tax credits is materially accurate. However, it is our recommendation that the current audit process employed by ESD personnel be modified and strengthened to further ensure the accuracy of the Tax Credits issued.

#### *Reliability of ESD's Financial Tracking of Application Data and Tax Credit Amounts*

The processes and resources employed by ESD in tracking the Application Data and the corresponding tax credits issued appears adequate. We did not encounter any variances through our comparisons of the information obtained through the Program database maintained by ESD and the underlying Applications and documentation retained or reporting of program activity and tax credits estimated/issued.

#### *Adherence to, and Compliance with, Program Laws and Regulations*

It appears that ESD has the appropriate processes in place to ensure compliance with Program Laws and Regulations relating to Applicant eligibility, incorporation of eligible costs and exclusion of ineligible costs and eligibility of the tax credit provided..

## **Post Production Credit**

### *Efficiency of ESD Operations*

The Initial and Final Application processes are appropriately designed and appear to be effective and efficient. As noted for the Film Production Credit, the most significant challenge facing the Program relates to the volume of Applications that have been received. In addition, it is likely the Program will see an increase in the number Post Production Applications that are received as the aggregate credit will be increasing to \$25 Million in 2015.

### *Accuracy of Tax Credits Issued*

Through our review of the Final Applications and related documents provided, it appears that the distribution of program assets and funds, in the form of tax credits is materially accurate. The procedures currently employed by the Program, as they relate to the Post Production Credit, appear adequately designed and the relative risk of inaccuracy of tax credits issued is considerably lower than with the Film Production Credit.

### *Reliability of ESD's Financial Tracking of Application Data and Tax Credit Amounts*

The processes and resources employed by ESD in tracking the Application Data and the corresponding tax credits issued appears adequate. We did not encounter any variances through our comparison of the information obtained through the Program database maintained by ESD and the underlying Applications and documentation retained.

### *Adherence to, and Compliance with, Program Laws and Regulations*

Through the procedures performed, it was noted that ESD has the appropriate processes in place to ensure compliance with Program Laws and Regulations relating to Applicant eligibility, incorporation of eligible costs and exclusion of ineligible costs and eligibility of the tax credit provided.

## **PROGRAM ACTIVITY FOR 2013 AND 2014**

The following table summarizes the Initial Applications received, the Final Applications received and Tax Credits issued for the Film Production Credit and Post Production Credit over the period January 1, 2013 – December 31, 2014:

<u>Film Production Credit</u>				
	<u>Initial Applications</u>	<u>Final Applications</u>	<u>Credits Issued</u>	<u>Projects</u>
2013	187	119	\$ 161,598,800	52
2014	193	127	446,661,931	119
<u>Post Production Credit</u>				
	<u>Initial Applications</u>	<u>Final Applications</u>	<u>Credits Issued</u>	
2013	68	19	\$ 497,076	3
2014	79	42	3,994,488	20

## **REVIEW OF PROGRAM COMPONENTS**

Through the procedures identified, Toski documented its understanding of the Film Production and Post Production Tax Credit Program. In addition, we obtained an understanding of the Initial and Final Application processes, as well as the audit process currently employed by ESD. Our understanding was obtained through review of the program information available through the ESD Film and Tax Credit web site, and augmented through discussion/interview with the ESD personnel identified.

## **FILM PRODUCTION CREDIT**

The Film Production Credit component offers a 30% tax credit on qualified costs incurred by a qualified production company that meets the eligibility criteria established by the State of New York. Tax credits through the Program are available to qualified production companies producing feature films, television series, relocated television series, television pilots and films for television. Qualified production costs are generally defined as production costs incurred, or the performance of services within, the State of New York directly and predominantly in the production of a qualified film.

### Eligibility Criteria

Based on our review of the Program Guidelines, eligibility requirements vary based on the type of company and the project/production budget. The general eligibility requirements for the Film Production Credit include:

- Productions with a budget greater than \$15 million, or produced by a company in which more than 5% of the beneficial ownership is owned (directly or indirectly) by a publicly traded entity:

- 10% or more of total principal photography shooting days must be at a Qualified Production Facility (QPF) in New York State
- Television pilots are exempt from the 10% requirement. A minimum of one day of principal photography must be shot at a QPF, and at least 75% of total of all expenses must be related to work done at QPF
- Productions with a budget of \$15 million or less, produced by independent companies must shoot at least one day of principal photography at a QPF
- If production costs are incurred at more than one production facility, 75% of all qualified costs incurred at all facilities must be incurred at a QPF
- If a qualified production has met the 75% threshold for QPF expenditures, it may also qualify for the credit based upon qualified expenditures outside the qualified facility that are related to pre-production, location production and post-production if:
  - The production spends less than \$3 million on all costs related to work done at a QPF, then a minimum of 75% of the principal photography days shot on location must be in New York State. This threshold requirement applies to location days only; or
  - The production spends \$3 million or more on all expenses related to work done at a QPF, then all qualified expenditures related to pre-production, location production and post-production in New York State are eligible for calculating the credit.

Upon determination that facility thresholds are met, all qualified costs related to work done at the facility become eligible for the credit.

## POST PRODUCTION CREDIT

The Post Production Credit also offers a 30% tax credit on qualified costs incurred by a qualified production company that meets the eligibility criteria established by the State of New York. The Credit is limited to the same type of projects as the Film Production Credit. However, the Post Production Credit is available on projects where principal photography/filming occurred outside New York State, but the qualified production company contracts the post-production work to specialized post-production companies within New York State.

### Eligibility Criteria

Based on our review of the Program Guidelines, the eligibility requirements for the Post Production Credit include:

- A qualified post-production facility is any company engaging in providing post-production services to film and television located in New York State
- A qualified production company is eligible for the post-production credit if it meets one or both of the following thresholds:

- Visual effects (VFX) and Animation – the qualified VFX/Animation costs incurred at a qualified post-production facility in New York State must either meet or exceed:
  - 20% of the total VFX/Animation costs paid or incurred for the qualified film
  - \$3 million
- Post Production – the qualified post-production costs incurred at qualified facilities in New York State must meet or exceed 75% of the total qualified post-production costs paid or incurred

A production company meeting the eligibility requirements for the Film Production Credit can include qualified post-production costs incurred in New York State in the calculation of the tax credit. However, a production company cannot claim the Film Production Credit and the Post Production Credit for the same qualified post production costs.

## APPLICATION PROCESS

The application process for the Film Production Credit and the Post Production Credit are essentially the same. The primary difference in the application processes for each primarily relates to the information/documents that are required to be submitted with the Initial and Final Applications and the requirements for submission of Initial Applications. The Initial Applications for the Film Production Credit are required prior to the start of principal and ongoing photography, while the Initial Applications for the Post Production Credit are required no later than the last day of principal photography.

The following steps to the Application Process are available to the public via the ESD Film Tax Credit web site. The steps identified were compared to the Application Process defined in Part 170 of the Regulations of the Commissioner of the Department of Economic Development for consistency. In addition, we confirmed the steps to the Application Process through discussion/interview with ESD personnel. Where applicable we have included additional detail or specific procedures identified through the interview process.

- 1.) An Initial Application is submitted to ESD via a general e-mail address, with the project title in the subject line of the e-mail.
- 2.) At ESD's discretion, an interview may be conducted between Program leadership and the project's producer and other relevant personnel to discuss the details of the Initial Application.
- 3.) The Initial Application is accompanied with the following documents:
  - a. Project Summary – Initial
  - b. Budget Cost Qualifier
  - c. Production Budgets
  - d. FOIL Letter – recommended, not required
- 4.) The Initial Application is reviewed by ESD personnel for completeness and accuracy. If deemed incomplete, the applicant is notified of the outstanding and/or additional documentation that is required.

- 5.) Information included with the Initial Application is entered into an Access database maintained by ESD. Information recorded includes Project Name, budgeted expenditures, projected qualified costs, anticipated tax credit and projected hires.
- 6.) Upon approval, eligibility for submission of Final Application is provided to the applicant. If requested, ESD will issue a Certificate of Conditional Eligibility.
- 7.) Submission of the Final Application is required within 60 days after the completion of the production of a qualified film.
- 8.) The Final Application is submitted to ESD via e-mail. The Final Application is accompanied by the following documents/information:
  - a. Project Summary – Final
  - b. Updated Budget Cost Qualifier with final cost information
  - c. General Ledger Detail
    - i. Film Production Credit – the entire project General Ledger must be submitted, along with specific General Ledger for qualified costs indicated in Budget Cost Qualifier
    - ii. Post Production Credit – General Ledger reports for qualified and non-qualified costs
  - d. Employment Report
  - e. End Credit Requirements and Frame Grab
  - f. Daily Production Reports – Film Production Credit only
  - g. Shoot Days Summary – Film Production Credit only
  - h. Cast & Crew List – Film Production Credit only
- 9.) The Final Application is reviewed for completeness by the assigned ESD staff and the Final Application Checklist is prepared. The Final Application Checklist is utilized to verify that all required documents/information have been submitted. If deemed incomplete, the applicant is notified and the outstanding information is requested
- 10.) Upon acceptance of the Final Application and confirmation of completeness, the applicant is notified of acceptance and the Application is queued for audit by ESD.
- 11.) The Program Director will assign the appropriate ESD staff to the Final Application/Project. The Final Applications are audited in order of date of receipt of a complete application. The Program Director and auditor assigned notify the applicant when the audit commences.
- 12.) Upon completion of the audit, a Final Review Memo is issued to the applicant, which details specific questions and/or requests for additional information/documentation. This additional information is incorporated into the audit process upon submission.
- 13.) After the audit is completed, the Final Application is reviewed by the Program Director and then forwarded to the Senior VP of Economic Incentives who performs a quality control review. The Final Application is then sent to the Commissioner for approval.
- 14.) Upon approval, a Certificate of Tax Credit is issued to the Applicant. The Certificate of Tax Credit details the completion date of the project and the allocation year of the credit.

## AUDIT PROCESS

The audit protocol currently employed by ESD, dated August 30, 2013, has been documented by an Intra-Office Memorandum. Based on our review of the Memorandum, it appears that the defined audit process contemplates the audit of Final Applications for the Film Production Tax Credit. It does not specifically address the audit process or procedures for the Post Production Tax Credit. However, through discussion with ESD personnel, it is our understanding that the process employed for the Post Production Applications is similar to the Film Production audit process.

The audit protocol utilized by the Program was developed to focus the review on all above-the-line costs, the major qualified cost items, most frequently disallowed cost items and a sampling methodology for other non-labor cost items. The process and protocol identified through review of the Memorandum and our interviews with ESD personnel is as follows:

- 1.) Final Applications received by the Program are reviewed for completeness.
- 2.) Final Applications deemed complete are dated based on the date of that completeness is determined. This date is used to determine allocation year for the Credit issued.
- 3.) Applicants of Final Applications deemed incomplete are notified with specific instructions regarding missing information/documentation. Once all outstanding information has been received, the date of receipt of the revised applications is used to determine allocation year for the Credit issued.
- 4.) Through review of the Budget Cost Qualifier, identify the most relevant “qualified cost” line entry items based on the following project size categories:
  - a. \$0-5 Million – Top 5 most relevant entries
  - b. \$5-20 Million – Top 10 most relevant entries
  - c. \$20-50 Million – Top 15 most relevant entries
  - d. \$50 Million + – Top 20 most relevant entries
- 5.) Obtain the underlying documentation for the entries identified based on the thresholds identified above.
- 6.) If other entries require further scrutiny to ensure eligibility requirements have been met, additional documentation should be requested as deemed necessary.
- 7.) General ledger reports for projects should be scrutinized for the following specific non-qualified cost items:
  - a. Above The Line – rights and clearance fees, WGA fees, airfare outside NYS, hotels, per diems in NYC within studio zone, actor salaries, producer and director fees, entertainment, gifts, luxury items, personal assistants.
  - b. Below The Line – In Art Department, licenses and fees for artwork, photos, stock footage, legal fees, finance charges, In transportation, deliveries, out of state taxes, out of state repairs, out of state tolls.
  - c. Post Production – License fees, versions beyond primary venue (TV versions of films, international versions, in-flight versions), trailers, promotion, music rights, composer fees, out of state salaries, hotels and per diems in NYC.
- 8.) Additional specific items in general ledger reports identified as non-qualified through the Schedule of Qualified Expenditures guidelines and instructions should be disallowed.

- 9.) Line item entries for all other non-labor costs should be reviewed for each budget category of qualified costs and requests for clarification and/or submission of documentation should be made when deemed necessary based on the following project size category thresholds:
  - a. \$0-5 Million – 3% of the entries in each budget category
  - b. \$5-20 Million – 7% of the entries in each budget category
  - c. \$20-50 Million – 15% of the entries in each budget category
  - d. \$50 Million + – 20% of the entries in each budget category
- 10.) Additional inquiries should be made, and documentation requested, if necessary to feel confident in making a final recommendation for issuing a tax credit.

Through discussion with ESD Program personnel, it was noted that, rather than employing the methodologies defined by the Audit Protocol, a manual and primarily judgmental audit process/methodology is employed. Generally speaking, specific categories on the general ledgers submitted by the Applicants with Final Applications are manually scanned, and suspect line item entries are selected for further documentation and/or investigation. The general ledgers are reconciled to the Budget Cost Qualifier documents submitted in aggregate, but it does not appear that specific accounts are reconciled to the general ledger.

### **DETAILED ANALYSIS OF PROJECTS**

As part of the procedures performed, Toski selected a sample of projects for which Tax Credits have been issued over the course of 2013 and 2014. Our sample included 25 projects which were issued credits for the Film Production Tax Credit and 5 projects which were issued credits for the Post Production Tax Credit. The value of the Tax Credits for the selections represents 44% (\$269M) and 51% (\$2.3M) of the total Tax Credits issued for the Film Production Credit and Post Production Credit, respectively.

For each of the projects selected, Toski obtained the following information:

- A. Initial Application and Required Information/Documentation
- B. Preliminary Budget(s)
- C. Final Application and Required Information/Documentation
- D. ESD Work papers documenting audit procedures
- E. Tax Credit calculation work papers

Upon receipt of the requested information, we reviewed each of the projects to assess, among other things, compliance with eligibility requirements relating to the production and the costs incorporated in the calculation of the Tax Credit, adherence to the audit protocol established by ESD, compliance with submission of required documents and to identify potential areas of strength and/or weakness.

## **CPA AGREED UPON PROCEDURES INSPECTIONS**

Beginning in 2015, Applicants will have the option of employing the services of a Certified Public Accountant (CPA) to perform an Agreed Upon Procedures (AUP) Inspection and prepare a report summarizing the results of the procedures to include with Final Applications. ESD has a list of sixteen pre-qualified CPA firms from which Applicants can select for the performance of the AUPs. The cost of the service is the responsibility of the Applicant, but ideally will help to expedite the Final Application review and approval process, and subsequently expedite the issuance of the tax credit. The AUP process is only available for Applicants of the Film Production Tax Credit, and ESD will allow Applicants who have submitted Final Applications prior to 2015, which are awaiting review and approval, to engage the services of one of the pre-qualified firms to help expedite their Final Application through the review and approval process.

As part of this engagement, we reviewed the Agreed Upon Procedures that will be employed to assist in determining sufficiency and applicability. The AUPs have been designed to help ensure that the eligibility requirements are met, that Final Applications are complete and supported by the information/documentation required by ESD, and that only qualified expenditures are included in the calculation of the tax credit. The guidance issued with the AUP guidelines includes a sampling methodology based on qualified expenditures and specific items in the general ledger, as well as a sampling methodology designed to test qualified payroll expenditures, and defines procedures for identifying a projected misstatement and for requiring additional sampling.

## **OBSERVATIONS/RECOMMENDATIONS**

### **General Observations/Recommendations**

- 1) As of December 31, 2014, there are 158 Final Applications for the Film Production Credit either in process or awaiting audit/review and issuance of the credit. There are 40 Final Applications for the Post Production Credit either in process or awaiting audit/review and issuance of the tax credit.
- 2) As illustrated, Tax Credits issued for 2014 amount to approximately \$446 Million and \$3.9 Million for the Film Production and Post Production Programs, respectively. This significantly exceeds the value of tax credits issued in any preceding year for either of the Programs. The Final Applications awaiting approval represent approximately \$524 Million and \$10 Million in estimated Film Production and Post Production Tax Credits, respectively.
- 3) Though our review of the Quarterly Reports prepared by ESD, as required by Program Regulations, it was noted that the Reports are based off of the *estimated* Tax Credits of Initial Applications that have been received. However, it appears that the Regulations require that the Quarterly Reports are to be based on the *actual* Tax Credits issued to projects. Beginning in 2015, reporting will incorporate actual Tax Credits issued.

## Initial and Final Application Processes

- 1) The Initial and Final Application processes appear appropriately designed and generally effective. However, improvements can be made on an organizational level. The following should be considered:
  - a. ESD should employ a FTP link through the website for the transfer of Initial and Final Applications and related documents.
  - b. ESD should employ an online Application interface. Ideally, this interface could connect to an internal database to populate key information gathered on the Initial and Final Applications.
  - c. ESD should consider employing a full-time Administrative Staff person to assist ESD staff by processing Initial and Final Applications and performing the Checklist/Validation procedures.
  - d. Formal standardized work papers should be designed and a standard audit program should be followed. In addition, the audit process should be more detailed and formalized.
  - e. A formalized training program should be designed and utilized to assist the introduction of new ESD staff to the Program. It will also assist in the successful transfer of knowledge and insight specific to Film Production is passed on from the Program Director to ESD staff.
  - f. General ledger detail received with Final Applications can be provided in a variety of formats. It is our recommendation that ESD require Applicants to include specific data elements that correspond to the Budget Cost Qualifier and the account numbers. This will help expedite the review and reconciliation process.
  
- 2) Through discussion with ESD personnel, the current workload and staff continuity is the primary barrier to the timely review and processing of Final Applications and the issuance of the corresponding Tax Credits. In addition to the Film and Post Production Credits, the ESD personnel are responsible for the administration and review of Commercial Tax Credits. Through discussion with ESD leadership, it was noted that ESD has been adding additional personnel to assist in working through the current backlog of Final Applications awaiting audit. Furthermore, the pre-qualified CPA firm AUP initiative will further help to alleviate the current workload.

## Audit Protocol/Processes

- 1) It is our recommendation that the Audit Process employed by ESD be updated to further ensure the accuracy of the Tax Credits that are issued. We suggest that the following modifications be made:
  - a. The audit process does not require the testing of qualified payroll expenditures. Payroll expenditures on the general ledger are reviewed for reasonableness and reconciled to the Budget Cost Qualifier and Employment Report. However, procedures should be designed to test the accuracy and legitimacy of payroll expenditures being incorporated in the calculation of the Tax Credit. Through review of the Final Applications selected as part of our sample, it was noted that qualified payroll expenditures, as a % of total qualified expenditures, ranged from 41% to 70%. This is inclusive of applicable payroll taxes and fringe benefits, and represents a significant amount of a project that is not being scrutinized or adequately tested. It was noted that payroll on most of the Final Applications selected for reviews was outsourced to specialized entertainment payroll service providers. It is our recommendation that ESD consider requiring the weekly invoice(s) from these providers be incorporated as a required piece of information/documentation to be submitted with a Final Application.
  - b. The audit process is reliant on a manual and primarily judgmental/intuitive review of the general ledger detail submitted for projects applying for the Tax Credit. This review is based on the experience of ESD personnel, which has provided them with unique insight and capability in identifying general ledger accounts/areas where non-qualified expenditures may have been reported. However, the audit protocol defines a sampling methodology for Final Applications, as illustrated, but it does not appear that the application of this methodology has consistently adhered to the guidance. It is our recommendation that ESD redesign the audit protocol and review process to require incorporation and adherence to a defined sampling methodology (similar to the AUP methodology) to supplement the judgmental/intuitive selection process, and that these sampling procedures be adequately documented and substantiated.
  - c. ESD should consider requiring that Applicants submit documentation (invoices/contracts, cancelled checks) with the Final Applications for all expenditures over a certain threshold (i.e., \$10,000). This may help to expedite the audit process.

## Analysis of Projects

- 1) Through our review of the sample of projects selected for detailed testing, it was noted that the Audit Protocol defined by ESD was not consistently employed. The departures relate primarily to the sampling/testing methodology defined by the protocol and the ultimate size of the audit samples/testing that were selected and submitted to the Applicants for documentation and/or clarification. We did not encounter any material issues related to the inclusion of non-qualified expenditures in the calculation of the tax credits issued.

- 2) We did not encounter any exceptions with respect to the Final Application Checklists and the information/documentation required to be submitted.
- 3) Through our review of the sample of projects, we did not encounter any exceptions related to project eligibility for either the Film Production or Post Production Credit Applications.
- 4) Through discussion with ESD personnel, the submission of general ledger detail in an Excel format has only recently been an explicit requirement. Prior to this requirement, general ledger detail could be submitted in a pdf format. ESD has an application capable of converting pdf files into an Excel format, and would utilize this if necessary to assist in the analysis of the Final Applications. However, through our review of projects selected, it was noted that many of the general ledgers that were submitted in a pdf format were not converted into Excel. It is our opinion that scanning the ledgers in a pdf format is an ineffective and inefficient process. We recommend that any Final Applications with general ledger files in a pdf format that are awaiting audit/review have the files converted to an Excel format and that these files be utilized exclusively for analysis.
- 5) Adjustments made to the Film Production Final Applications selected for testing ranged from 0% to 1.86% of the total Qualified Expenditures submitted. Twenty-two of the twenty-five Film Production Applications and three of the five Post Production Applications selected were under 1.00%. It is our recommendation that ESD monitor adjustments indicated on the reports received from the pre-qualified CPA firms performing the AUP engagements on Final Applications for comparative purposes.

#### CPA AUP Inspections

- 1.) As designed, the AUPs appear adequately designed to provide reasonable assurance that the Final Applications received relate to qualified projects and materially reflect qualified expenditures.
- 2.) Through discussion with ESD personnel, the Program does not have a standardized report or review process in place for the AUP Reports and supporting workpapers that are provided. It is anticipated that a formalized and standardized report and workpaper template will be determined as the AUP Inspection process evolves. However, it is our recommendation that ESD draft a report template, based on AICPA guidance and Government Auditing Standards (“Yellow Book”) regarding AUP engagements, that can be distributed to the pre-qualified contractors.
- 3.) ESD should formally require that contractors conform to guidance issued by the AICPA and Government Auditing Standards regarding AUP engagements with respect to independence, planning, conducting and reporting on the results of the engagement. Requiring adherence to this guidance may help to ensure a standardized work product.

- 4.) It is our recommendation that ESD perform detailed internal audits of the initial AUP Reports that are received as this program begins in 2015. The primary objective will be to assess the effectiveness of the AUPs and the reliance that can be placed on them. Based on the results of these initial AUP engagements, It may be necessary for the ESD to revise the procedures and/or continue to perform certain audit procedures, including the manual review of certain cost categories.
  
- 5.) If the CPA AUP Inspection program does not help to alleviate the backlog of Final Applications awaiting audit/approval, ESD should consider employing the services of a contractor to assist in the audit process.