Iowa Department of Economic Development
Des Moines, Iowa

Consulting Engagement
August 19, 2009 – September 30, 2009

Clifton Gunderson LLP
Certified Public Accountants & Consultants

Iowa Department of Economic Development
Mr. Richard Oshlo
Interim Director
200 East Grand Avenue
Des Moines, Iowa 50309

Dear Mr. Oshlo:

In connection with our consulting engagement, we have attached the following comments for the consideration of management of the Iowa Department of Economic Development (IDED). This report covers procedures performed at various times during August 19, 2009 through September 30, 2009.

Our engagement to perform these procedures was conducted as a consulting service engagement. We performed our engagement in accordance with the *Statement on Standards for Consulting Services of the American Institute of Certified Public Accountants*. The engagement is also subject to contract 10-BD-01. We were not engaged to, and did not, conduct an audit, the objective of which would be the expression of an opinion on any financial statement elements, accounts and items, or the internal control over financial reporting of IDED. Accordingly, we do not express any such opinion. In addition, we did not perform any management functions or make any management decisions as a result of this engagement.

Our engagement consisted of performing procedures as listed in the following report and agreed to by management of IDED. Procedures were performed at the IDED office in Des Moines, Iowa, solely to assist in department administration and operations. The sufficiency of the procedures is solely the responsibility of IDED management. Consequently, we make no representation regarding the sufficiency of the procedures, either for the purpose for which has been requested or for any other purpose.

The procedures preformed were limited, and therefore, our findings may not necessarily disclose all significant matters. If we were to perform additional procedures, other matters might come to our attention that would have been reported to you.

These comments are intended solely for the information and use of the IDED management, and others within IDED and are not intended to be and should not be used by anyone other than these specified parties.

Clifton Gunderson LLP

West Des Moines, Iowa
October 1, 2009

Initially Requested Scope of Engagement

The original procedures to be performed were as follows:

A review of all Film, Television, and Video Project Promotion project files where tax credit certificates have been issued. Review of the 22 project files will be performed in a manner to determine compliance with Iowa Code Sections 15.391- 15.393 and Iowa Administrative Code Chapter 261-36.

The review will consist of, but not be limited to, the following:

1. Comparison of budgeted expenditures with actual receipts submitted by the recipient with a notation of discrepancies in the amount and type of expenditures such as:
   a) Capital Expenditures – items such as aircraft, vehicles, audio and visual equipment.
   b) Salary and Fringe Costs – including whether costs are in conformance with guidelines set forth in Iowa Code Section 15.393.
   c) Types of expenditures (lease versus purchase of capital items)
2. Review of all other expenditures as budgeted and submitted by recipient.

Consultation Procedures Performed

We started the engagement as outlined above by the Iowa Department of Economic Development (IDED). However, we quickly discovered that we did not have sufficient information to perform the requested procedures. For example, vendor invoices were only received for two of the twenty-two projects. We expediently met with IDED management to discuss our initial findings and received approval of the changes in the scope of the engagement. The revised procedures were as follows:

1. Request all electronic information from the Iowa Film Office Manager, Tom Wheeler.
2. Develop electronic and paper files for each project.

3. Identify any situations that may require additional interpretation.
4. Request information from the production companies to verify the certificate value.

We contacted Mr. Wheeler to begin organizing the files and obtain background information on the projects. Mr. Wheeler provided to us what we were told was all available information. Mr. Wheeler was responsible for approval of applications, review of expenditures, calculation of qualifying expenditures, and issuance of certificates. The Director, Michael Tramontina, and the Deputy Director, Vince Lintz, were responsible for signing and reviewing all contracts as well as issued certificates.

The amount of time initially budgeted to perform the review was greatly exceeded. The files provided to us had limited information, and were inadequate to perform the review. A data base that was designed to track the status of the projects had not been used. The majority of the documentation was in e-mail format, with thousands of e-mails being reviewed. Until recently, we did not anticipate issuing a formal consulting report. The construction and review of files was a very time consuming process.

Due to the significant change in scope of the engagement, many meetings were held with management to discuss the various issues that needed to be addressed. The lack of invoices, signatures, proof of payment, and overall documentation caused an alteration to our procedures on a number of occasions.

Findings

Our findings from steps 1, 2, and 3, are summarized below. There are a number of different areas or items that appear unclear, or that may be questionable to qualify under Iowa statutes. It appears many of these areas may need policy clarification, or potential legislation depending on the intent of the legislation. In addition, we identified certain IDED procedures that were not followed, or may need to be revised. Furthermore, in consultation with management, it was decided that various issues needed to be resolved prior to completing step 4.

Due to confidentiality concerns and lack of complete documentation, we have not cited specific production companies related to the various questions that we have listed below. For clarification purposes, some general examples are listed in some of the areas we identified.

Incomplete or Inadequate Records

Film Office files for all projects were maintained in a disorganized fashion. Despite being engaged to review all 22 projects which received tax credits, we found that vendor invoices and/or receipts had been received by the Film Office for only 2 of these 22 projects. We also noted that the custom-made data base that IDED had developed for tracking the status of the projects had not been used.

Contracts

Upon review, various inconsistencies with the contracts were noted. Contracts were apparently being changed and not identified as amended/revised contracts. The Director or Deputy Director did not appear to have been notified of the changes. The primary change in the contracts was the budget being increased. The contract often had the same date as the original contract. We were unable to identify any contracts formally labeled as amended. In certain instances, it appeared that the signature and review documents signed by IDED management were moved from the original IDED contract to the revised contract. We did not identify any communication or documentation by IDED management that the signature pages were to be moved from the original to the revised contract. There were also instances where we were unable to locate documents signed by management identifying that the contracts had been through the review process.

Broker's Fees

Often, the tax certificates awarded to the investors and producers were transferred to other taxpayers. The tax credits are purchased by the taxpayer from the investors and producers at a negotiated discount. Brokers are used to find buyers for the tax credits. Fees are paid to the brokers by the investors and producers, usually structured on a contingent fee basis of 3 to 4 percent of the certificate value. In many cases, the broker's fees were included as qualifying Iowa expenditures used to calculate the Iowa credits, even though the certificates had not yet been issued. Thus, the expenditure for broker's fees actually occurred after the issuance of the certificate.

We identified amounts for broker's fees included in the qualifying expenditures which exceed $100,000 for certain films. The total amount of broker's fees included in the productions exceeded $500,000, generating in excess of $250,000 in tax credits.

Pass Through Entities

In certain instances, limited liability companies (LLC's) were established as Iowa-based companies to purchase property and services from in-state and out-of-state companies, as well as labor. By passing these costs through the Iowa-established business, the expenditures were claimed as qualifying Iowa expenditures. However, there were instances where the majority of the purchases of property and labor appeared to have originated from out-of-state sources. In certain instances, we were unable to verify that all the entities had been established as Iowa based business and/or were registered with the Iowa Secretary of State's office incorporated in Iowa.

In certain films the total amount of expenditures that were run through Pass Through entities exceeds 40% of the total qualifying expenditures, with some totaling more than one million dollars.

Out of State Expenditures

In certain circumstances, expenditure reports submitted by producers included some detail related to purchases. Some of the purchases listed on the report clearly indicated an out-of-state address; however, they were included as qualified Iowa expenditures.

For instance, two of the out-of-state purchases for a certain production were $1,000,000 each, accounting for over 50% of the total qualifying expenditures for that specific production.

Possible Non-qualified Labor

Director, producers, and principal talent are specifically excluded from qualified expenditures according to Iowa Law. We noted instances where the individuals identified in the contracts/applications for the non-qualifying positions, were paid for other services, or an entity that appears be owned by those individuals was paid for other services. These other services were claimed as qualifying expenditures, and some of the expenditures exceeded $100,000. However, we were unable to verify what was paid to those individuals for the non-qualifying services of producer or director. We did not locate documentation verifying the expenses related to each role.

In one of the productions, it appeared that the total amount of expenditures that may be non-qualifying exceeded $300,000, and in another production the non-qualifying amounts approved exceeded $650,000.

Deferred Payments

In certain films, we identified many expenditures that were claimed as qualifying expenditures that were referred to as "deferred payments". Some of the amounts listed on the invoice were clearly marked as "deferred" and appear that they were not paid until after certificates were brokered to cash. Though some or all of the amounts were deferred, the entire amount was claimed as qualifying Iowa expenditure. Often the invoices appeared to be printed by the production company and signed only by the production company. We identified more than a 100 expenditures classified as deferred, with some amounts exceeding $100,000.

Often these expenditures were accompanied a "Deal Memo". These memos indicated that the payment due to the vendor will be paid when the tax incentives vouchers are brokered into cash.

In two of the productions, the amounts identified as deferred exceeded 50% of the total qualifying expenditures. In those two productions, we identified over 25 invoices with the majority of the individual amounts deferred exceeding $100,000.

Sponsorships/Advertising

Organizations were contracted by production companies to provide advertising for the films, often referred to as "sponsorships". In return, the sponsoring organization would generally receive advertising from the production company in the film or on merchandise related to the production. In these situations, no cash was exchanged, but the amount was included as an Iowa qualifying expenditure. In certain productions, we indentified this situation multiple times, with some amounts exceeding $1,000,000 for each sponsorship.

A specific production had 4 sponsorships at $1,250,000 each, totaling more than 75% of the total qualifying expenditures. We were able to identify a total of 12 sponsorships exceeding $1,000,000 or more for each sponsorship, all of which were listed as qualifying Iowa expenditures totaling $13,400,000.

Possible Non-production Related Expenditures

It appears possible that some of the expenditures included as qualifying Iowa expenditures may not have directly been involved with the film production. We were not able to determine that these expenditures were questioned by Mr. Wheeler in the review process. Examples include, but would are not limited to, luxury vehicles, as well as items donated to non-profit organizations. These included large expenditures with some exceeding $50,000 each. However, due to lack of invoices or other documentation, it was not possible to quantify how many purchases could be considered non-production related expenditures.

Similar Relationships Between Entities

It appears various Iowa entities were established for certain key roles in the production such as investor, production company, producer, accountant, and broker. In certain instances, individuals or family members would have sole or partial ownership in these entities. Some of these individuals or entities were paid for services claimed as qualified expenditures. These expenditures varied in amounts, but many exceed $50,000, with specific expenditures exceeding $300,000.

Certificates

We were unable to locate all signed certificates. In addition, there were certain productions we were unable to locate the documentation identifying total qualifying Iowa expenditures which equals the amount used to calculate the tax credit certificates. According to Iowa Rule (36.7(1) b), "the tax credit shall not exceed 25 percent of the qualified expenditures on a project". This is referred to as an Expenditure Credit. The tax credit shall not exceed 25 percent of the investment in the project, according to Iowa Rule (36.8 (1) b). This is referred to as an Investment Credit. Of the twenty-two projects, six were issued a 50% Expenditure Credit, and three a 50% Investment Credit. However, no projects were noted that the total value of the certificates issued exceeded 50%. In addition, some of the certificates were not issued to the investor or the producer. Instead, they were issued directly to the transferees.