

STATE OF CONNECTICUT

**AUDITORS' REPORT
CONNECTICUT INNOVATIONS, INCORPORATED
FOR THE FISCAL YEARS ENDED JUNE 30, 1998 AND 1999**

AUDITORS OF PUBLIC ACCOUNTS
KEVIN P. JOHNSTON ❖ ROBERT G. JAEKLE

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**AUDITORS' REPORT
CONNECTICUT INNOVATIONS, INCORPORATED
FOR THE FISCAL YEARS ENDED JUNE 30, 1998 AND 1999**

We have made an examination of the financial records of the Connecticut Innovations, Incorporated for the fiscal years ended June 30, 1998 and 1999.

Financial statements pertaining to the operations and activities of Connecticut Innovations, Incorporated for the fiscal years ended June 30, 1998 and 1999, are presented and audited on a Statewide Single Audit basis to include all State agencies and funds. We have relied on the financial and compliance audits conducted by the Corporation's independent public accountant covering the fiscal years mentioned above, after having satisfied ourselves as to the firm's professional reputation, qualification and independence, and verifying that generally accepted accounting principles and auditing standards were followed in the audits and in the preparation of the reports. Financial statements of the Corporation are included in the Corporation's Annual Reports for 1998 and 1999.

In addition to reviewing the audits and related working papers prepared by the independent public accountants, we reviewed State statutory compliance requirements, tested certain internal control procedures, followed up on prior audit recommendations and reviewed the minutes of the Corporation's meetings. We conducted our audit in accordance with generally accepted government auditing standards for financial related audits. This report on our examination consists of the following Comments, Condition of Records and Recommendations.

COMMENTSCOMMENTS

FOREWORDFOREWORD:

Connecticut Innovations, Incorporated operates primarily under Chapter 581, Sections 32-32 through 32-47a of the General Statutes. Pursuant to Section 32-35 of those Statutes, it is a public instrumentality and political sub-division of the State. Also, pursuant to Chapter 12 of the General Statutes, it is classified as a quasi-public agency subject to various statutory requirements related to those agencies. As a quasi-public agency the Corporation's financial information is included as a component unit in the State of Connecticut's Comprehensive Annual Financial Report (CAFR).

Connecticut Innovations, Incorporated was established to stimulate and promote technological innovation and application of technology within Connecticut and to encourage the development of new products, innovations, and inventions or markets in Connecticut by providing financial and technical assistance.

Financial assistance is given to Connecticut businesses for the marketing and development of high-technology products, services and processes. This assistance has been contributed in the form of loans, royalty agreements and equity (ownership) investments. In recent years the Corporation has used equity agreements as its primary vehicle for investing in businesses. The Corporation also provides other organizations (Connecticut universities, technology research or application centers, etc.) funds. The Corporation includes contingent payback provisions to those funds as a means of sharing in the royalties and other earnings from successful research projects.

Connecticut Innovations, Incorporated targets high-technology areas for its involvement. They include: advanced marine applications, advanced materials, aerospace, biomedical technology, energy and environmental systems, information and technology and photonics. To address these areas the Corporation utilizes a number of limited partnerships and financial investments to achieve its objectives of assisting qualified Connecticut companies, colleges and universities.

Connecticut Innovations, Incorporated provides several basic financial and technical programs and corresponding funds to assist qualifying Connecticut companies and Connecticut colleges and universities:

Eli Whitney Investments – This program makes risk capital investments in emerging and established companies to stimulate their development of high technology products, processes and services.

Technology Assistance Center Program – This program was developed as an information clearinghouse to help Connecticut firms and individuals interested in starting or growing technology driven enterprises and developing leading edge products and processes.

Access Connecticut Limited Partnership – This program is designed to generate new

Connecticut technology companies through technology transfer from universities. The Limited Partnership also assumed many of the objectives of the revised Connecticut Technology Development Corporation, as noted below.

Connecticut Seed Venture Limited Partnership – This program invests in start-up Connecticut companies by providing early stage financing. The funds under this program have been fully invested.

Yankee Ingenuity Initiative Program – This program was developed to encourage high-technology research and development and training at Connecticut’s colleges and universities.

Connecticut Technology Development Corporation – This program has been revised and the objectives will be accomplished in the future through Access Connecticut Limited Partnership and through Connecticut Innovations, Incorporated.

Connecticut Technology Partnership (CTP) Program – This program provides programs that supplement and leverage federal research and development dollars. The CTP offers two types of awards: (1) Small Business Innovation Research/Small Business Technology Transfer (SBIR/STTR) awards of up to \$50,000, which are used by companies to help commercialize SBIR and STTR projects; and (2) federal match awards of up to \$500,000, which are used for research and development and contribute to a company’s match funding requirements under federal programs requiring a match.

Connecticut Emerging Enterprise Limited Partnership – This program is a recently formed partnership between the Corporation and a major commercial bank. The program invests in initial and follow-on rounds of financing for early stage, technology growth enterprises with significant proprietary innovations or other unique, sustainable competitive advantages.

Investments in Biotech Facilities – This program was developed to enable the development of laboratory space in Connecticut in order to encourage the growth of biotechnology research and companies.

During the period under review two significant initiatives were passed by the Connecticut State Legislature that have the potential to significantly effect the future operations of the Corporation:

Public Act 98-28 – An Act Concerning Electric Restructuring established the Corporation as manager of the State’s Renewable Energy Investment Fund which will promote development of renewable and alternative energy technologies.

Public Act 99-223 – An Act Concerning Development and Use of New or Experimental Products Made in Connecticut formed a partnership between the Corporation and the

Office of Policy and Management to operate the new test bed program. The test bed program gives companies access to the resources of State agencies to field test new products in order to demonstrate their worth to potential customers. Also, the Act provides that the Corporation shall evaluate the feasibility of establishing a bio-processing facility within the State. If feasible, the Corporation will assist in developing such a facility.

Organizationally, Connecticut Innovations, Incorporated is divided into three major areas:

- Finance and Administration - responsible for disbursements, accounts payable, collections, accountability, and all other administration matters.
- Investments - primary purpose is to provide capital for invention and innovation when financial aid is not available from commercial sources.
- Technology - provides technical and informational assistance as well as research grant programs for universities and small business.

Board of Directors and Administrative Officials

Pursuant to section 32-35 of the General Statutes, Connecticut Innovations, Incorporated is governed by a 15 member Board consisting of 12 appointees of various elected officials and three State office holders. The Commissioner of the Department of Economic and Community Development, the Commissioner of the Department of Higher Education and the Secretary of the Office of Policy and Management, serve as ex-officio members of the Board of Directors by virtue of their office.

Of the 12 appointed members, eight are appointed by and serve at the pleasure of the Governor. The Governor is required to appoint at least six who are knowledgeable in technology. The four remaining appointees are chosen by various legislative leaders. Appointed members serve at the pleasure of the appointing authority. Board members receive no compensation, but are entitled to reimbursement for expenses incurred in the performances of their duties.

As of June 30, 1999, the members of the Board of Directors were as follows:

Ex Officio:

Valerie F. Lewis, Interim Commissioner of Higher Education
Timothy H. Coppage, designee for Commissioner of Economic and Community Development
Benson Cohn, designee for the Secretary of the Office of Policy and Management

Governor Appointments:

Arthur H. Diedrick, Chairman
Anthony J. Campanelli

Geraldine U. Foster
Scott Guilmartin
George Lewson
John W. Olsen
Daniel Rappaport

Legislative Appointments:

Thomas Clark
Katherine Vick
E. Charles McClenachan

As of June 30, 1999, there was one vacancy on the Board. During the audited period the following individuals served on the Board: Bruce Carlson, Policy Development Director at the Office of Policy and Management served as an ex-officio director; Andrew G. De Rocco, former Commissioner of the Department of Higher Education; Paul R. Pescatello, Special Counsel for the Governor at the Connecticut Department of Economic and Community Development served as an ex-officio director; Alan K. Greene, legislative appointment; and, Michael M. Danchak, legislative appointment.

Subsection (c) of Section 32-35 provides that the Chairperson of the board shall be appointed by the Governor with the advice and consent of the Legislature. Arthur Diedrick has served as Chairperson since January 1, 1995.

The Board appointed Victor Budnick as Acting President and Executive Director effective September 8, 1994. At its October 16, 1995 meeting, the Board appointed Victor Budnick as the President and Executive Director.

RÉSUMÉ OF OPERATIONS**RÉSUMÉ OF OPERATIONS:**

The State of Connecticut has provided significant financing for Connecticut Innovations, Incorporated programs through the proceeds of its General Obligation Bonds. These bond proceeds and net income from operations are used to finance the Corporation's grants and investments.

Bond payments are processed through the State Comptroller's centralized payment system and are recorded on both the State and Corporation books with the exception of certain pass-through grants; Beginning in the fiscal year ended June 30, 1999, those pass-through grants were reported in the Statement of Revenues and Expenses of the Corporation's Financial Statements. In addition, the Corporation uses the centralized State payment system for processing other

operating expenses primarily involving payroll. As noted above, bond payments are recorded in both the State's and Corporation's records. For instance, State bond proceeds to finance loans and investments are recorded by the State Comptroller as expenditures, and by the Corporation as investments and as contributed capital.

Similarly, payroll expense is recorded in the records of both the Corporation and the State. As provided for by Subdivision (b) of Section 32-41a of the General Statutes, all investment income and loan repayments are deposited into the Corporation's "operating account."

State Accounts:

State expenditures related to Connecticut Innovations, Incorporated include, as indicated above, bond fund proceeds to finance various grants and investments. They also include certain operating expenses processed through the State's centralized processing systems. These transactions are processed through two State Funds - a special revenue fund and an enterprise fund (Connecticut Innovations Incorporated Fund). The special revenue fund is used to process certain grant awards authorized by the Legislature through various authorizing special acts and the action of the State Bond Commission.

Special Revenue Fund expenditures amounted to \$2,891,478 in 1997-1998 and \$2,935,579 in 1998-1999. These payments consisted primarily of grant payments for the Critical Technologies Program, Yankee Ingenuity Initiative Grants Program and Connecticut Technologies Partnership Program.

The expenditure decrease of \$4,549,669 in 1997-1998 from the prior year's total of \$7,441,147 was primarily due to decreased State support for these programs and a shift to increased reliance on funds generated by the operations of the Corporation.

The enterprise fund (Connecticut Innovations, Incorporated) is authorized by Section 32-41a of the General Statutes. That Statute provides that this fund be used to account for bond fund moneys authorized by the State Bond Commission in accordance with Sections 32-41 and 32-41b of the General Statutes. Total bond fund moneys authorized by Sections 32-41 and 32-41b amounted to \$115,395,600 as of June 30, 1999. Expenditures charged to the fund include the Eli Whitney Investments, various technology loans, and payroll costs. A summary of fund expenditures for the audited period, as compared to the preceding fiscal year follows:

| | Fiscal Year Ended June 30, | | |
|-------------------|-----------------------------------|--------------------|--------------------|
| | <u>1997</u> | <u>1998</u> | <u>1999</u> |
| | \$ | \$ | \$ |
| Personal Services | 1,149,765 | 1,017,826 | 1,469,158 |
| Fringe Benefits | 380,840 | 365,784 | 522,263 |
| Investments | 5,271,479 | 2,365,832 | 586,589 |
| All other | <u>6,994</u> | <u>3,186</u> | <u>723</u> |

| | | | | | |
|---------------|----|----|------------------|----|------------------|
| Totals | \$ | \$ | <u>3,752,628</u> | \$ | <u>2,578,733</u> |
| | | | <u>6,809,078</u> | | |

The decrease in expenditures in the last two fiscal years, is attributable to a reduction in State bond allocations for investments, grants and loans. This decline in funding corresponds with the Corporation's increasing use of internally generated funds from its return on investments, loans and grants with payback provisions.

Connecticut Innovations, Incorporated Accounts:

As indicated above, pursuant to Subdivision (b) of Section 32-41a of the General Statutes, all investment income, loan repayments, and grants with payback provisions are deposited into a Corporation account (i.e. "operating account"). The operating account is used to pay administrative expenses including the transfers to the enterprise fund for reimbursements of personal services, fringe benefits and other administrative costs charged to the fund.

Any excess funds in the operating account are transferred to the State Treasurer's Short Term Investment Fund (STIF) to earn investment income. It should be noted that the Corporation may be required by the Bond Commission to repay the moneys advanced by the Bond Commission, including interest, under terms the Commission might find desirable and consistent with the purposes of the Corporation.

As of June 30, 1999, the Bond Commission had not requested repayment of any principal or interest. As presented in its audited financial statement, the Corporation's Balance Sheet for June 30, 1999, was as follows:

Assets

| | | |
|---|----|--------------------|
| Cash and cash equivalents | \$ | 63,006,309 |
| Investments and loans | | 41,648,647 |
| Other current assets | | 346,840 |
| Furniture, equipment and leasehold improvements | | 96,508 |
| Other assets | | <u>13,397</u> |
| Total Assets | | <u>105,111,701</u> |

Liabilities and Fund Balance

| | | |
|---------------------|--|---------------|
| Liabilities: | | |
| Current Liabilities | | 1,978,687 |
| Deferred Revenue | | <u>32,650</u> |

Auditors of Public Accounts

| | |
|---|------------------------------|
| Total Liabilities | <u>2,011,337</u> |
| Fund Equity: | |
| Contributed capital (State of CT. Bond Funds) | 78,355,991 |
| Retained earnings | <u>24,744,373</u> |
| Total fund equity | <u>103,100,364</u> |
| Total Liability and Fund Equity | \$ <u><u>105,111,701</u></u> |

Connecticut Innovations, Incorporated makes risk capital investments of up to \$5,000,000 in high technology products developed by applicant companies. Investments greater than that amount are possible with Board approval. The Corporation primarily makes investments in equity securities of emerging high-tech companies (i.e. warrants, stocks, etc.). It has substantially eliminated the use of royalty financing arrangements during the audited period but continues to recover the cost and revenues of past royalty arrangements. The Corporation now has 86 percent of its investments in equity securities.

In the absence of readily determined market values, investments are carried at fair value as determined by the valuation committee of the Corporation.

The Corporation also infrequently provides working capital loans to Connecticut companies to bring new high technology products to market. Loans may be used for any business-related purpose such as hiring, marketing, inventory buildup and capital expenditures; they may not, however, be used for product development. A loan must be repaid within six years according to an arranged payment schedule. Also, the loan agreement can include a warrant for the Corporation to purchase stock in the companies.

Interest on loans amounted to \$531,441 in 1997-1998 and \$563,718 in 1998-1999. The Corporation's royalty revenues amounted to \$445,395 in 1997-1998 and \$103,626 in 1998-1999. Interest on short-term investments and cash deposits amounted to \$2,453,720 in 1997-1998 and \$2,734,856 in 1998-1999. The Corporation's short-term investments consist primarily of investments in the State Treasurer's Short Term Investment Fund.

Combined net unrealized and realized gains on investments were \$13,256,053 and \$22,118,832 for the fiscal years ending June 30, 1998 and 1999, respectively. The large increases of such gains over the prior period's \$7,969,883 in net unrealized and realized gains is attributable to significant increases in portfolio values, continued new investments and gains realized from the sale of securities.

Other Examinations:

As previously noted, independent public accountants audited Connecticut Innovations, Incorporated during our audited period. Those audits attested that, the combined financial statements presented fairly, in all material respects, the financial position of Connecticut Innovations, Incorporated for the years under review, and the results of its operations and cash

flows for those years in conformity with generally accepted accounting principles. The Report of the independent public accountants included an explanatory paragraph regarding the Corporation's use of estimates to determine the fair value of a significant portion of its assets in the absence of readily ascertainable market values.

They concluded that the procedures used to arrive at the estimated values of such investments were reasonable and appropriately documented. The independent public accountants noted, however, that "because of the inherent uncertainty of valuation, those estimated values may differ significantly from the values that would have been used had a ready market for the investments existed, and the differences could be material."

As part of these examinations, the independent public accountants provided compliance reports and reports on the internal control structure.

The compliance reports relate to the requirements of Section 1-122 of the General Statutes. This section requires organizations including Connecticut Innovations, Incorporated to comply with regulations concerning affirmative action, personnel practices, the purchases of goods and services, the use of surplus funds and the distribution of loans, grants and other financial assistance. The compliance reports disclosed no instances of noncompliance concerning these requirements. The reports on the internal control structure indicated that no material weaknesses in internal control were identified.

CONDITION OF RECORDS PROGRAM EVALUATION

There were no recommendations developed as a result of this audit examination.

RECOMMENDATIONSRECOMMENDATIONS

Status of Prior Audit Recommendations:

- Connecticut Innovations, Incorporated should continue to upgrade its financial reporting. Our current review noted two areas of financial reporting that were part of the prior audit recommendation that would benefit from additional disclosures in the notes or other information accompanying the financial statements. Beginning with fiscal year ending June 30, 1999, the Corporation includes all pass-through grants in its Statement of Revenues and Expenses. Due to a significant shift to equity funding as the primary investment vehicle the second part of the recommendation is no longer applicable.
- Connecticut Innovations, Incorporated should prepare a written procedures' manual covering the Corporation's fiscal and reporting operations. Our review disclosed that the Corporation has established formal written procedures. Therefore, the prior audit recommendation will not be repeated.
- Connecticut Innovations, Incorporated should ask the State legislature to review the need for and intent of Section 32-47a. The Corporation has produced and transmitted the "annual business plan" as required by Section 32-47a beginning in the period under review. The prior audit recommendation has been addressed.

Current Audit Recommendations:

There were no recommendations developed as a result of this audit examination.

CONCLUSIONCONCLUSION

We wish to express our appreciation for the cooperation and courtesies extended to our representatives by the personnel of the Connecticut Innovations, Incorporated during our examination.

Michael R. Adelson
Associate Auditor

Approved:

Kevin P. Johnston
Auditor of Public Accounts

Robert G. Jaekle
Auditor of Public Accounts