

# STATE OF CONNECTICUT

**AUDITORS' REPORT  
CONNECTICUT INNOVATIONS, INCORPORATED  
FOR THE FISCAL YEARS ENDED JUNE 30, 2003 and 2004**

**AUDITORS OF PUBLIC ACCOUNTS  
KEVIN P. JOHNSTON ♦ ROBERT G. JAEKLE**

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March 14, 2006

**AUDITORS' REPORT**  
**CONNECTICUT INNOVATIONS, INCORPORATED**  
**FOR THE FISCAL YEARS ENDED JUNE 30, 2003 and 2004**

We have made an examination of the financial records of the Connecticut Innovations, Incorporated (the Corporation) for the fiscal years ended June 30, 2003 and 2004.

**Scope of Audit:**

This audit was primarily limited to performing tests of the Corporation's compliance with certain provisions of laws, regulations, contracts and grants, including but not limited to a determination of whether the Corporation has complied with its written operating procedures, that are required per Section 32-35 (d) of the General Statutes, concerning the following areas:

- Affirmative action
- Personnel policies
- Purchase of goods and services
- Use of surplus funds
- Distribution of loans, grants and other financial resources

We also considered the Corporation's internal control over its financial operations and its compliance with requirements that could have a material or significant effect on the Corporation's financial operations in order to determine our auditing procedures for the purpose of evaluating the Corporation's financial operations and compliance with certain provisions of laws, regulations, contracts and grants, and not to provide assurance on the internal control over those control objects. Our consideration of internal control included the five areas identified above.

Our audit included a review of a representative sample of the Corporation's activities during the fiscal year ended June 30, 2004, in the five areas identified above and a review of such other areas as we considered necessary. The compliance audit for the fiscal year ended June 30, 2003, and the financial audits for both of the fiscal years under review, were conducted by the Corporation's independent public accountants, whose work we relied on after having satisfied ourselves as to the

firms' professional reputation, qualifications and independence, and verifying that generally accepted accounting principles and auditing standards were followed in the audits and in the preparation of the reports. The Corporation's financial statements are included in its Annual Reports for 2003 and 2004.

This report on our examination consists of the Comments, Recommendations and Certification that follow.

## COMMENTS

### FOREWORD:

Connecticut Innovations, Incorporated (hereafter CI or the Corporation) 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 subdivision of the State. The Corporation is also responsible for administering the Renewable Energy Investment Fund, commonly referred to as the Connecticut Clean Energy Fund (CCEF), as required under Section 16-245n of the General Statutes. Pursuant to Chapter 12 of the General Statutes, it is classified as a quasi-public agency and therefore is subject to the requirements related to such agencies as may be found in Chapter 12. 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).

CI was established to stimulate and encourage the research and development of new technologies and new products, the development and operation of science parks and incubator facilities and, to promote science, engineering, mathematics and other disciplines essential to the development of technology.

The Corporation provides financial assistance to Connecticut businesses for the development and marketing of high-technology products, services, and processes. This assistance has been made 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 funds other organizations such as Connecticut universities and technology research or application centers. The Corporation includes contingent payback provisions to those funds as a means of sharing in the royalties and other earnings from successful research projects.

The Corporation targets early stage high-technology enterprises. These include: advanced materials, aerospace, biotechnology, energy and environmental systems, information 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 organizations.

The Corporation provides several financial and technical programs to assist qualifying Connecticut companies, colleges and universities. These include:

**Access Connecticut Limited Partnership** – This program is a limited partnership designed to generate new technology companies in Connecticut through technology transfer from

universities.

**Connecticut Emerging Enterprise Limited Partnership** – This program is a 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.

**Connecticut Innovations Technology Scholars Program** – This program provides scholarships to encourage talented young people to choose careers in science and technology and to pursue their education and their careers in Connecticut. During the 2003-2004 fiscal year, the Board authorized this program to be run through the Connecticut Innovations Educational Foundation (CIEF). Details about the CIEF are included later in this report.

**Connecticut Technology Partnership (CTP) Program** – This program provides funds 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.

**Eli Whitney Investments** – This is the Corporation's primary investment program. The program makes risk capital investments in emerging and established companies to stimulate their development of high technology products, processes and services. Areas of focus include bioscience, information technology and photonics.

**Next Generation Ventures LLC** – This program is a joint venture between the Corporation and a major commercial insurer. The program invests in start-up and young technology companies in Connecticut by the use of seed or early stage financing.

**Yankee Ingenuity Technology Program** – This program was developed to encourage technological innovation through partnerships between Connecticut businesses and Connecticut colleges and universities.

**BioScience Facilities Program** – This program encourages the growth of Connecticut's bioscience industry by providing financing to qualified biotechnology companies for the construction of laboratory and related space.

**Connecticut BioSeed Program** – This program was established to help accelerate the growth of early-stage biotech enterprises in Connecticut.

**Connecticut Clean Energy Fund** – As required under Section 16-245n, CI administers this Fund. It was created under Public Act 98-28 as the Renewable Energy Investment Fund. The Fund is intended to promote the production and utilization of clean energy, and is commonly referred to as the Connecticut Clean Energy Fund (CCEF). Although the CCEF should be considered a CI program, its financial records and activities are kept separate from CI, as its purpose is distinctly different from that of CI. A separate independent audit is done

for the CCEF.

In addition, in the footnotes to its financial statements for the fiscal year ended June 30, 2004, the following organizations are identified as blended component units of the Corporation, that, although legally separate entities, are in substance, part of the Corporation's operations:

**Connecticut Technology Development Corporation (CTDC)** – The CTDC is a CI wholly owned for-profit corporation, used during the 2003-2004 fiscal year, to address the need by new biotech firms for wet laboratory space in “move-in” condition. The CTDC activities during the 2003-2004 fiscal year consisted mainly of leasehold improvements at 25 Science Park in New Haven, reported as \$1,229,072 during the fiscal year ended June 30, 2004. Total net cash disbursements of the CTDC, during the fiscal year ended June 30, 2004, were \$1,513,181. These amounts are included in the Corporation's financial statements.

**Connecticut Innovations Educational Foundation (CIEF)** – The CI Board approved the creation of the CIEF at its May 14, 2001 meeting. It is a non-stock corporation, exempt from federal income taxes under Internal Revenue Code Section 501(c)(3), in which CI is the sole member. At its March 22, 2004 meeting, the Board authorized several CI and CCEF programs to be run through the CIEF, including the Technology Scholar Program, the Yankee Ingenuity Technology Competition, the Clean Energy Freedom Bus, and the Connecticut Clean Energy Fund Yankee Ingenuity Technology Competition. The Board approved funding to the Foundation in the aggregate amounts of \$825,000 for CI programs and \$1,500,000 for CCEF programs. During the 2004 fiscal year, the CCEF provided \$600,000 to the Foundation, none of which was expended by the Foundation as of June 30, 2004. CI presents that the Foundation was created so that it could solicit funds from external sources as a 501(c)(3) corporation, to provide additional funding for the programs. Apparently, the Foundation was not successful in its fund raising efforts, and CI plans to discontinue its operation.

Organizationally, the Corporation is divided into four major areas:

- Finance and Administration - responsible for accounting, administration, finance, and information technology support.
- Investments – responsible for identifying opportunities that fall within the Corporation's scope and providing where appropriate capital for invention and innovation when financial aid is not available from normal commercial sources.
- Marketing and Business Development – responsible for marketing support and the development of new business opportunities.
- Connecticut Clean Energy Fund Operations – responsible for the operation of the Connecticut Clean Energy Fund.

**Significant State Legislation:**

**Statutory Cash Transfers to the State of Connecticut General Fund** - Public Act 02-1, Section 41 (b), of the May 9, 2002 Special Session, required CI to transfer \$7,500,000 to the State's General Fund for the fiscal year ended June 30, 2003. Public Act 03-1, Section 46 (d), of the June 30, 2003 Special Session, required CI to transfer \$5,000,000 to the State's General Fund for the fiscal years ended June 30, 2004 and June 30, 2005. All of the required transfers have been made.

**Bond Authorization** - Special Act 02-1, Sections 23 and 24 (a), of the May 9, 2002 Special Session, effective July 1, 2003, provides the State Bond Commission with the power to authorize the issuance of bonds for CI, not exceeding \$5,000,000, for the purpose of providing financial aid for biotechnology and other high technology laboratories, facilities and equipment.

**Rate Reduction Bonds** - Public Act 03-6, Section 50, of the June 30, 2003 Special Session, effective August 20, 2003, amended Section 16-245n, subsection (b), of the General Statutes to provide for a plan to avoid disbursements from the Connecticut Clean Energy Fund to the General Fund. This resulted in the State issuing Special Obligation Rate Reduction Bonds-2004 Series A on June 23, 2004, the proceeds from which were used in lieu of the direct transfers. One-third of the one mill statutory ratepayer assessment will be used to cover the debt service portion on the bonds, resulting in a reduction in the Connecticut Clean Energy Fund revenues of an estimated \$8,600,000 per year.

**Board of Directors and Administrative Officials:**

Pursuant to Section 32-35 of the General Statutes, a 15-member Board of Directors governs the Corporation. Eight members are appointed by the Governor and four are appointed by various legislative leaders. In addition, 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. 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.

As of June 30, 2004, the members of the Board of Directors were as follows:

Appointed by the Governor:

Arthur H. Diedrick, Chairperson  
John T. Booth  
Anthony J. Campanelli  
J. Scott Guilmartin  
George Lewson  
John W. Olsen  
Paul R. Pescatello  
Daniel Rappaport

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### Legislative Appointments:

Thomas J. Clark  
Geraldine U. Foster  
Barbara Gay Nicholson  
E. Charles McClenachan

### Ex-Officio:

Valerie F. Lewis, Commissioner of Higher Education  
James F. Abromaitis, Commissioner of Economic and Community Development  
John A. Mengacci, Undersecretary of the Office of Policy and Management

James A. Lash served on the Board as a legislative appointee during the audited period.

The Board experienced a significant number of changes after June 30, 2004, as summarized below:

### Resignations:

Arthur H. Diedrick  
John T. Booth  
Anthony J. Campanelli  
J. Scott Guilmartin  
George Lewson  
Geraldine U. Foster

### Appointments through August 29, 2005:

Elaine Pullen, Chairperson  
Rafael A. Santiago  
George W. Schiele  
R. Carol Muradian

Also, Fred Maryanski and Theresa Yerkes served on the Board after June 30, 2004. As of August 29, 2005, there were two vacancies.

Arthur Diedrick served as Chairperson of the Board during the audited period, and until his resignation in July 2004. Elaine Pullen was appointed as Chairperson on February 23, 2005.

In addition, the Board has set up several Committees and Sub-committees to expedite certain of the Corporation's business as well as to maintain controls over its transactions. These committees include a Governance Committee that the Board approved at its April 22, 2005 meeting to review the Corporation's written policies and internal controls and recommend any changes to them.

Victor Budnick served as President and Executive Director of CI since October 16, 1995, until his resignation on March 31, 2005. Arnold B. Brandyberry was the Acting President and Executive Director, effective April 1, 2005, until the CI Board appointed Chandler J. Howard as President and Executive Director, effective September 1, 2005.

### **RÉSUMÉ OF OPERATIONS:**

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The State of Connecticut provided significant initial financing for the Corporation's programs through the proceeds of General Obligation Bonds. It is these bond proceeds and any net income from operations that are used to finance the Corporation's investments.

Bond payments are processed through the State Comptroller's centralized payment system and are recorded on both the State and the Corporation books. The State Comptroller records State bond proceeds to finance loans and investments as expenditures, while the Corporation records them as investments and as contributed capital.

The Corporation also uses the centralized State payment system for processing payroll and other operating expenses. 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:**

As indicated above, State expenditures related to Connecticut Innovations, Incorporated include 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 \$4,037,104 and \$4,995,395 in the 2002-2003 and 2003-2004 fiscal years, respectively, compared to zero in the 2001-2002 fiscal year. The monies received are to be used for BioScience Facilities; to enable biotechnology and other technology companies to make leasehold improvements to production, testing, research, development, manufacturing, laboratory, and other related facilities.

The Connecticut Innovations Incorporated Fund is an enterprise fund authorized by Section 32-41a of the General Statutes. That Statute provides that this fund be used to carry out the purposes of CI, and also for the repayment of State bonds when required by the State Bond Commission. Total bond fund monies authorized by Sections 32-41, 32-41b, and 31-41o, amounted to \$114,801,000 as of June 30, 2004. Expenditures charged to the Fund during the audited period consisted almost entirely of payroll costs, which were funded by cash transfers from CI to the Fund. A summary of Fund expenditures for the audited period follows:

	<b><u>Fiscal Year Ended</u></b>	
	<b><u>June 30, 2004</u></b>	<b><u>June 30, 2003</u></b>
	\$	\$
Personal Services	2,625,001	3,381,190
Fringe Benefits	1,130,067	1,357,782
All other	<u>0</u>	<u>1,813</u>
Totals	<u>\$ 3,755,068</u>	<u>\$ 4,740,785</u>

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The decrease in Personal Services and fringe benefits is due to a reduction in staff. There were no State expenditures made from the Enterprise Fund for investment purposes. Previously, the Corporation used such expenditures for Eli Whitney Investments, various technology loans, and to fund BioScience Facilities. As indicated above, the Corporation received monies from the Special Revenue Fund to be used for BioScience Facilities.

### **Connecticut Innovations, Incorporated Accounts:**

As previously indicated, 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, 2004, the Bond Commission had not requested repayment of any principal or interest.

The financial position of the Corporation as of June 30, 2003 and 2004, per its audited financial statements, is presented below. These amounts do not include the Connecticut Clean Energy Fund.

<b>Assets</b>	<b><u>As of June 30,</u></b>	
	<b><u>2004</u></b>	<b><u>2003</u></b>
Current Assets:	\$	\$
Unrestricted assets:		
Cash and cash equivalents:		
Cash	991,008	1,859,403
Short-term investments	<u>19,125,586</u>	<u>19,742,750</u>
Total cash and cash equivalents	<u>20,116,594</u>	<u>21,602,153</u>
Marketable securities	150,000	150,000
Current portion of investments	1,489,418	2,326,444
Due from related parties	314,635	813,777
Other assets	<u>1,113,359</u>	<u>1,182,551</u>
Total unrestricted current assets	<u>3,067,412</u>	<u>4,472,772</u>
Restricted assets:		
Short-term investments	<u>5,000,000</u>	<u>3,698,126</u>
Total current assets	<u>28,184,006</u>	<u>29,773,051</u>
Non-Current Assets		
Unrestricted assets:		
Investments in programs	59,497,413	77,820,203
Less current portion	<u>(1,489,418)</u>	<u>(2,326,444)</u>
Investments - non-current	58,007,995	75,493,759
Capital assets, net of depreciation	<u>1,460,252</u>	<u>272,212</u>

Total unrestricted non-current assets	59,468,247	75,765,971
Restricted assets:		
Short-term investments	<u>10,000,000</u>	<u>-</u>
Total non-current assets	<u>69,468,247</u>	<u>75,765,971</u>
<b>Total Assets</b>	<b><u>\$ 97,652,253</u></b>	<b><u>\$ 105,539,022</u></b>
<b>Liabilities and Net Assets</b>		
Liabilities		
Accounts payable and accrued expenses	\$ 613,239	\$ 746,269
Due to related parties	<u>13,766</u>	<u>10,042</u>
Total liabilities	<u>627,005</u>	<u>756,311</u>
Net Assets		
Invested in capital assets	1,460,252	272,212
Unrestricted	80,564,996	100,812,373
Restricted	<u>15,000,000</u>	<u>3,698,126</u>
Total net assets	<u>97,025,248</u>	<u>104,782,711</u>
<b>Total Liabilities and Net Assets</b>	<b><u>\$ 97,652,253</u></b>	<b><u>\$ 105,539,022</u></b>

The Corporation makes risk capital investments of no more than six million dollars, with the approval of the Finance Committee of the Board of Directors, in high technology applicant companies. Investments greater than six million dollars are possible, with approval of the full Board of Directors. The Corporation primarily makes investments in equity securities of emerging high-tech companies. It has substantially eliminated the use of royalty financing arrangements but continues to recover the cost and revenues of past royalty arrangements. The Corporation has approximately 70 percent of its investments in equity securities.

In the absence of readily determined market values, investments are carried at fair value as estimated by the valuation committee of the Corporation, using United States Private Equity Valuation Guidelines promulgated by the Private Equity Investment Guidelines Group. As is commonplace with investments such as those held by CI, and as disclosed in the CI's audited financial statements, due to the inherent uncertainty of valuation, those estimated values may differ significantly from the amounts ultimately realized from the investments, and the differences could be material.

CI 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. Loan agreements can include warrants allowing the Corporation to purchase stock in the companies.

A schedule of revenues, expenses and change in net assets for the fiscal years ended June 30, 2003 and 2004, follows. The information was obtained from the Corporation's audited financial statements, and does not include the Connecticut Clean Energy Fund.

	<b><u>Fiscal Year Ended June 30,</u></b>	
<b>Operating Revenues:</b>	<b><u>2004</u></b>	<b><u>2003</u></b>

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Interest on short-term investments and cash deposits	\$ 265,332	\$ 392,893
Interest on investments	1,514,635	1,378,565
Other income	<u>1,269,241</u>	<u>2,029,043</u>
Total Revenue	<u>3,049,208</u>	<u>3,800,501</u>
<b>Operating Expenses:</b>		
Compensation and benefits	1,949,097	2,661,855
General and administrative expenses	<u>1,821,717</u>	<u>2,097,957</u>
Total operating expenses	<u>3,770,814</u>	<u>4,759,812</u>
Net Operating Loss	<u>(721,606)</u>	<u>(959,311)</u>
<b>Non-Operating Revenues (Expenses):</b>		
Unrealized loss on investments	(12,587,255)	(12,544,136)
Realized gain (loss) on sale of investments	6,485,220	(206,161)
Grants and Programs	<u>(929,217)</u>	<u>(1,399,914)</u>
Total non-operating expenses	<u>(7,031,252)</u>	<u>(14,150,211)</u>
<b>Change in Net Assets Before Capital Contributions and Statutory Transfers</b>	(7,752,858)	(15,109,522)
<b>Statutory Transfers to the State of Connecticut</b>	(5,000,000)	(7,500,000)
<b>Capital Contributions [from the State of Connecticut]</b>	<u>4,995,395</u>	<u>4,037,104</u>
<b>Change in Net Assets</b>	<u>\$ (7,757,463)</u>	<u>\$ (18,572,418)</u>

The Corporation's short-term investments consist primarily of investments in the State Treasurer's Short Term Investment Fund.

The negative Changes in Net Assets Before Capital Contributions and Statutory Transfers resulted mainly from unrealized losses on investments that continued throughout the audited period. Although the unrealized loss appears to have been consistent over the two-year period, there were better overall results during the 2004 fiscal year ended, as the realized gains on the sales of investments should be considered together with the unrealized loss.

The Corporation's financial results were reflective of the overall results in the equity markets, which experienced their most significant decline during the 2001-2002 fiscal year. Although the decline continued over the next two years, it was significantly lower. Emerging high-tech companies, which make up a large portion of the Corporation's portfolio, were heavily impacted in both the public and the private markets over the period.

The CI Board approved \$12,475,000 and \$5,177,326 for investments during the fiscal years ended June 30, 2003 and 2004, respectively, and funded \$14,205,224 and \$9,388,144 in those respective fiscal years. The Eli Whitney Fund and the Bioscience Facilities Fund comprised the majority of the approved and funded amounts. In addition, CI provided funding of over \$2,000,000 for grants and scholarships during the audited period.

**Connecticut Clean Energy Fund:**

The Renewable Energy Investment Fund (commonly referred to as the Connecticut Clean Energy Fund) was established in July 1998 under Title 16, Section 16-245n of the General Statutes. Said Section requires that Connecticut Innovations administer the Connecticut Clean Energy Fund.

Section 16-245n provides that on or after January 1, 2000, the Department of Public Utility Control shall assess or cause to be assessed a charge per kilowatt-hour to each end-user of electrical service in the State. It is this assessment that provides the financing for the Fund. Unlike the majority of Connecticut Innovations' investments, the Connecticut Clean Energy Fund is not limited to Connecticut businesses. CI is authorized to use any amount in the Fund for expenditures that promote investment in renewable energy sources in accordance with a comprehensive plan developed by it to foster the growth, development and commercialization of renewable energy sources, related enterprises and stimulate demand for renewable energy and deployment of renewable energy sources which serve end use customers in this state. Such expenditures may include, but not be limited to, grants, direct or equity investments, contracts or other actions which support research, development, manufacture, commercialization, deployment and installation of renewable energy technologies, and actions which expand the expertise of individuals, businesses and lending institutions with regard to renewable energy technologies.

The Fund's two key strategic thrusts are the support of renewable energy technologies (fuel cell, wind, solar, biomass conversion, tidal energy, ocean thermal, etc.) and infrastructure and market support (education and outreach, tradable renewable certificates, entrepreneurial stimulation, etc.).

Section 16-245n, subsection (d), establishes a Renewable Energy Investments Advisory Committee to assist CI in matters related to the Connecticut Clean Energy Fund. The committee shall consist of not more than 12 individuals with knowledge and experience in matters related to the purpose and activities of the Fund. Three of the members are appointed by the Connecticut Innovations' Board of Directors. Of the remaining nine members, two shall be State officials appointed by the Governor, one shall be a Gubernatorial appointee with experience regarding renewable energy resources and one member each is appointed by the Speaker of the House of Representatives, the President Pro-Tem of the Senate, the majority leaders of the House of Representatives and the Senate, and the minority leaders of the House of Representatives and the Senate. This Advisory Committee is known as the Clean Energy Advisory Board of the Connecticut Clean Energy Fund. There is also a Clean Energy Committee of the CI Board of Directors currently made up of three CI Board members. Before any investment or grant proposal, etc., is funded, it must be approved by the Clean Energy Committee, which generally acts on the recommendations made by the Advisory Board.

The members of the Connecticut Clean Energy Fund Advisory Board as of June 30, 2004, were as follows:

Timothy Bowles  
Peter L. Cashman  
Marian Chertow  
Donald W. Downes  
Richard C. Lichter  
John Mengacci

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Norman Richards, Ph.D.  
Margery C. Winters

Appointed by the Board of Directors of Connecticut Innovations Inc:

Arthur H. Diedrick, Chairman  
Jerome P. Peters, Jr.  
John W. Olsen

There was one vacancy as of June 30, 2004, which was subsequently filled with the appointment of William T. Sellay. Also, Arthur H. Diedrick subsequently resigned from the Board and his replacement has yet to be named. Timothy Bowles is currently the Chairman.

The financial position of the Connecticut Clean Energy Fund as of June 30, 2003 and 2004, as presented in its audited financial statements, follows:

	<b><u>As of June 30,</u></b>	
	<b><u>2004</u></b>	<b><u>2003</u></b>
<b>Assets</b>	\$	\$
Cash and short-term investments	37,509,248	26,419,089
Utility Customer Assessments Receivable	5,616,543	0
Total investments and programs	2,593,770	4,965,853
Other assets	68,395	43,091
Short-term investments-Restricted	<u>1,040,875</u>	<u>1,291,606</u>
<b>Total Assets</b>	<b><u>\$ 46,828,831</u></b>	<b><u>\$ 32,719,639</u></b>
<b>Liabilities and Net Assets</b>		
Liabilities:	\$	\$
Due to Connecticut Innovations	286,008	786,852
Accrued Expenses	<u>258,164</u>	<u>32,509</u>
<b>Total Liabilities</b>	<b><u>544,172</u></b>	<b><u>819,361</u></b>
Net Assets:		
Restricted	1,040,875	1,291,606
Unrestricted	<u>45,243,784</u>	<u>30,608,672</u>
<b>Total Net Assets</b>	<b><u>46,284,659</u></b>	<b><u>31,900,278</u></b>
<b>Total Liabilities and Net Assets</b>	<b><u>\$ 46,828,831</u></b>	<b><u>\$ 32,719,639</u></b>

Connecticut Clean Energy Fund revenue, expenses and the change in net assets for the fiscal years ending June 30, 2003 and 2004, is presented below. The information was taken from the Connecticut Clean Energy Fund audited financial statements for those fiscal years.

	<b>Fiscal Year Ended June 30,</b>	
	<b>2004</b>	<b>2003</b>
<b>Revenues:</b>	\$	\$
Utility Customer Assessments*	25,827,103	21,069,427
Interest on investments and cash deposits	<u>364,906</u>	<u>337,819</u>
<b>Total Revenues</b>	<u>26,192,009</u>	<u>21,407,246</u>
 <b>Expenditures/Expenses:</b>		
General and administrative expenses	2,577,525	2,621,914
Grants and programs	<u>4,469,390</u>	<u>4,130,240</u>
<b>Total Expenditures/Expenses</b>	<u>7,046,915</u>	<u>6,752,154</u>
<b>Change in Net Assets Before Changes in the Fair Value of Investments</b>	19,145,094	14,655,092
Net realized gain (loss) on investments	0	(1,350,000)
Net decrease in the fair value of investments	<u>(4,760,713)</u>	<u>(1,449,508)</u>
<b>Net Change in Net Assets</b>	14,384,381	11,855,584
Net assets, beginning of year	<u>31,900,278</u>	<u>20,044,694</u>
<b>Net assets, end of year</b>	<u>\$ 46,284,659</u>	<u>\$ 31,900,278</u>

\*Utility Customer Assessments were presented as “Contributed Capital” in the June 30, 2003 financial statements.

The increase in revenues resulted from an increase in kilowatt hours assessed, as the assessment rate over the audited period was constant at three-quarters of one mill. Effective July 1, 2004, the assessment rate was increased to one mill. However, with the issuance of the Rate Reduction Bonds discussed earlier in this report, the Connecticut Clean Energy Fund’s revenue from the one mill assessment will be reduced by the portion that is required to pay debt service on those bonds. It is estimated that Fund revenues will be reduced by some \$8,600,000 per year as a result.

In the 2004 fiscal year, the fair value of the Fund’s investments decreased by \$4,760,713, bringing the total investment losses as of June 30, 2004, to \$12,185,432, of which \$2,396,565 has been considered realized. The Fund’s investments at cost as of June 30, 2004, was \$12,382,637 and the valuation committee determined the fair value of those investments to be \$2,593,770. Most of the Fund’s investments were made in the early stages of the Fund’s existence. As the Fund has evolved, it was determined that grant programs would provide more immediate results, and accordingly, CI shifted the Fund’s focus from making investments to providing grants. Most of the recipients of the Fund’s monies are selected based on detailed reviews of information submitted in response to the Fund’s Requests for Proposals, which vary depending upon the particular program within the Fund. Investments still remain an option for the Fund.

During the 2004 fiscal year the Board approved \$9,668,000 for new grants and programs. As of June 30, 2004, unfunded Board approvals outstanding totaled \$23,160,177, the bulk of which was for fuel cell initiatives (\$15,155,357) and solar energy initiatives (\$4,024,611).

From its inception through the audited period, the CCEF did not have written procedures in place to accept and review investment or other proposals that came to it. In the early stages of the Fund, when investments were the prevalent form of financial aid, there apparently were unwritten rules as

to how the investment proposals that were received would be handled; however, there was no positive structure and the proposals that were received were not always handled in a consistent manner. As the Fund moved toward being more grant oriented, informal procedures were established. Those procedures appeared adequate and our tests of selected transactions during the audited period found that they were being followed. Subsequent to June 30, 2004, the CI adopted written formal procedures pertaining to the CCEF and the awarding of contracts for projects involving the expenditures from the CCEF. Those procedures were published in the Connecticut Law Journal and approved by the Board.

**Other Examinations:**

Independent public accountants audited the Corporation's financial statements and those of the Connecticut Clean Energy Fund for each of the two years under review. Those audits attested that the financial statements presented fairly, in all material respects, the financial position of Connecticut Innovations, Incorporated and the Connecticut Clean Energy Fund for the years under review, and the results of its operations for those years in conformity with generally accepted accounting principles.

The independent public accountants' reports 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. Essentially, it was concluded that the procedures the Corporation used to arrive at the estimated values of its investments were reasonable and appropriately documented; however, 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 an integral part of their financial statement audits, the independent public accountants also provided reports on compliance and on internal control over financial reporting. These 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.

**Subsequent Events:**

**Whistleblower Investigation:**

Our Office received a whistleblower complaint, under Section 4-61dd of the General Statutes, alleging improprieties of certain transactions executed through the Connecticut Clean Energy Fund. CI also received written information concerning this matter. CI presented the information it received to its Board of Directors at its September 10, 2004, special meeting, in which the Board ordered an independent investigation and eventually hired a private firm to conduct it. That investigation was completed in March 2005, and the results were reported to the Board, in Executive Session, at its March 28, 2005 meeting. We reviewed the complaint, using information obtained from the private investigator and from the CI and the CCEF. We completed our review and reported our findings to the Attorney General's Office, as required under Section 4-61dd. In addition, our review resulted in findings that we reported to the Governor and other State Officials, as required under Section 2-90 of the General Statutes (See the "Condition of Records" section of this report, under the caption "Non-Compliance with Written Procedures - Requests for Proposals").

## CONDITION OF RECORDS

### CI Created Portfolio Companies and Conflict of Interest Matters:

- Background:* In an effort to facilitate the development of the biotechnology industry in the State, in April 1999, the CI Technology Committee approved a pilot program that could have resulted in CI creating three new companies from university research funded by CI. One company, Hepaticus, Inc., came about from that program after two \$100,000 investments supporting a research program in human liver cell development resulted in a commitment of \$400,000 from the CT BioSeed Fund in September 2001. CI created the company in October 2001, with three of its employees listed as its Principals. The CI Executive Director was the Hepaticus Chairman. Subsequent CI funding totaled an additional \$1,200,000 through June 30, 2004, and \$1,500,000 after that. Hepaticus is clearly a CI related party.
- Criteria:* Instances in which transactions present a potential conflict of interest should be avoided.
- Condition:* CI hired a former employee as a consultant immediately after the employee resigned from CI. The former employee played a significant role in the development of Hepaticus, Inc., and as a consultant was to spend approximately 30 hours per week as the Chief Executive Officer (CEO) of Hepaticus, Inc., with the remaining ten hours per week to be spent on CI matters. Prior to hiring the consultant, CI entered into an agreement with Hepaticus that required Hepaticus to reimburse CI for the hours that the consultant worked as the CEO. The Hepaticus Chairman, who as previously indicated, was also the CI Executive Director, proposed the reimbursement arrangement to CI and the CI Executive Vice President (also a Hepaticus Principal (Director)), agreed to it. The consultant wound up working almost exclusively as the Hepaticus CEO until the consulting agreement expired, one year and one week after execution, and was then hired as the CEO on a permanent basis. We note that CI had inquired of the Ethics Commission about the consulting agreement; however we had concerns about whether all of the relevant information was provided to the Commission. Accordingly, to determine whether all State Ethics statutes have been complied with in this instance we forwarded certain information related to this matter to the Office of State Ethics for consideration. The salary of the former employee as the permanent CEO (\$200,000 base annual) was almost twice that of the amount received as a CI employee (\$105,000 base annual).
- Effect:* A former CI employee was permitted to benefit significantly from a CI created company that the former employee was involved in establishing.

*Cause:* Nothing in the General Statutes specifically prohibits CI employees from benefiting from employment with a company that CI has created. Also, nothing in the General Statutes specifically prohibits CI from creating a company like it did with Hepaticus, Inc.

*Recommendation:* CI should refrain from allowing its employees to benefit from employment with any portfolio company that it has created. (See Recommendation 1.)

*Agency Response:* “CI recognizes the important public purpose served by the provisions of the Code of Ethics that prohibit use of official positions for personal financial benefit and the related “revolving door” provisions governing post-state employment. CI considers any arrangement with a former employee in light of these guiding ethics principles. In connection with the independent contractor and employment arrangements involving Hepaticus, CI was insistent that advance approval be obtained from the State Ethics Commission in order to be sure that the fees and compensation proposed to be received by the former CI employee in this case would be permitted under the Code of Ethics. With the assistance of experienced outside counsel, all facts with respect to these arrangements believed to be relevant to Code of Ethics considerations were presented to staff of the State Ethics Commission, including the fact that the former CI employee had been personally and substantially involved in the initial formation of the company, a description of the proposed method of calculation and payment of independent contractor fees by CI, and the fact that the compensation of the former CI employee was expected to be higher when hired as an employee of the company. A letter of inquiry with respect to the independent contractor arrangement was submitted by outside counsel to CI on April 30, 2003, and a letter of inquiry with respect to the employment arrangement was submitted by the former CI employee on July 14, 2004. In both cases, State Ethics Commission staff felt that informal staff advisory opinions would be sufficient in the circumstances, and favorable staff opinions were received on May 2, 2003, and August 9, 2004, respectively. Both the letters of inquiry and the responses were provided to the Auditors. The Auditors noted, and CI has confirmed, that there were certain inaccuracies in the description in the July 14, 2004 letter of inquiry of the former employee’s independent contractor arrangement at that time. The July 14, 2004 letter represented that the former employee was continuing as an independent contractor to CI on a week-to-week basis pending a response from the State Ethics Commission. A review of CI’s files indicates, however, that the former employee was engaged as an independent contractor to the company starting May 24, 2004. Therefore, the characterization in the July 14, 2004 letter of inquiry of a direct engagement of the former employee by the company as an independent contractor as “possible” was incorrect since that direct engagement took effect before the date of the letter. CI accepts responsibility for these inaccuracies, since it had an opportunity

to review a draft of the July 14, 2004 letter of inquiry before it was submitted by the former employee. It should nevertheless be noted that the direct engagement of the former CI employee as an independent contractor to the company came after the expiration of the one-year “revolving door” period measured from the date of termination of employment with CI. Nevertheless, CI will advise the new Office of State Ethics of the inaccuracies in the July 14, 2004 letter of inquiry. While CI continues to believe that there was no ethics violation in this case, we recognize that legitimate questions have been raised about arrangements effected through CI whereby a former CI employee benefits financially from a post-state employment relationship with a portfolio company created by CI. Therefore, as a matter of policy going forward, CI will no longer make or sponsor any such post-state employment arrangements. The Auditors’ comments also focus on the fact that CI was reimbursed by the company for the time devoted to company matters by the former employee when working as an independent contractor to CI. This was discussed with Ethics Commission staff but not specifically mentioned in the letter or inquiry because it was not a matter of ethics concern. In fact, this approach, with the fees of the CI independent contractor set and paid by CI, and then reimbursed at cost by the company so they were properly borne by the party receiving the benefit of those services, was modeled on similar arrangements approved in earlier ethics opinions. See, *e.g.*, Advisory Opinions Nos. 2003-8 and 2000-7 and the related letters of inquiry.

**Investment Opportunity Outside of CI’s Statutory Authority:**

*Background:*

We reviewed a transaction involving the attempted formation of a Small Business Investment Company (SBIC), ConnVergence Capital, LP (subsequently changed to New Growth Capital Partners, LP and referred to as “New Growth” in this report). An SBIC is a privately owned and operated equity fund that is required to receive a license from the U.S. Small Business Administration (SBA). CI worked together with a Limited Liability Corporation in which it had a 50 percent interest, Next Generation Ventures, LLC (NextGen), to set up New Growth and apply for the license, as CI could not do it directly. CI was to become one of two members of the General Partner (NextGen was to be the other) as part of the investment management team, and a Limited Partner with a \$7,500,000 commitment to New Growth. The SBIC licensee was to be New Growth. Under the proposed scenario, CI’s \$7,500,000 commitment to New Growth could have resulted in up to \$150,000,000 in funds available for investing. It was CI’s intention to acquire added funding through this SBIC, rather than through the State of Connecticut. This transaction was initiated during the 2001 fiscal year, and CI made its initial cash investment as a limited partner in New Growth in April 2003. That money was returned to CI in July 2004.

*Criteria:* The SBA determined that CI's funds would qualify as "Qualified Non-Private Funds" under Section 107.230(d) of the SBIC regulations. However, under that regulation, for CI funds to be eligible for investment in the proposed SBIC, it must not control, directly or indirectly, a Licensee's management, or its Board of Directors or general partners.

Section 32-39 of the General Statutes states in part "The purposes of the corporation (CI) shall be to stimulate and encourage the research and development of new technologies and products...and other disciplines that are essential to the development and application of technology within Connecticut..."

*Condition:* The SBA, in a letter dated November 20, 2001, expressed its concerns about certain aspects of the proposed SBIC. Those concerns included the level of control that CI might have over the general partner (in this case, NextGen). The SBA also was concerned about the geographic operating area of the proposed SBIC being limited to companies located in Connecticut or committed to relocation of all or a significant portion of their operations to Connecticut.

Our review disclosed that, in response to the SBA's concern about CI's control over the general partner, in a letter to the SBA dated November 27, 2001, NextGen presented that CI *has* a minority interest in NextGen, when at the time it was apparent that CI and Phoenix Home Life Mutual Insurance Company each had a 50 percent interest. Our review disclosed that CI backdated its Second Amendment to its agreement with NextGen so that it indicated CI's ownership to be 49 percent when the representation to the SBA was made. It was clear from the documentation we reviewed that CI's attorneys provided a blacklined copy of the agreement to CI's Executive Director, representing changes made January 10, 2002, which included striking out "January \_\_, 2002" as the date the amendment was entered into, and replacing it with May 18, 2001. The signature page of the amendment was not dated. It appears that the main purpose of the amendment was to reduce CI's interest to that of a minority interest, in an effort to meet the SBA's control requirement.

In response to the concern about the geographic operating area, New Growth expanded the area to cover the Mid-Atlantic and Northeastern geographies, from Boston to Baltimore. These potential investments that New Growth would have held appear to reach beyond CI's statutory authority, as they included areas for investment outside of Connecticut.

It is evident that CI attempted to find ways around the issues raised by the SBA. The issues that were raised presented that the proposed SBIC was not an investment opportunity that was clearly within CI's statutory authority.

*Effect:* CI's attempt to find ways around the issues that the SBA raised early in the application process resulted in CI incurring expenses unnecessarily.

*Cause:* Although CI was aware of the issues that the SBA raised early in the application process, rather than discontinuing the process CI attempted to find ways around those issues.

*Recommendation:* CI should pursue only investment opportunities that are clearly within its statutory authority. (See Recommendation 2.)

*Agency Response:* "CI's effort to form a Small Business Investment Company ("SBIC") was squarely within its statutory authority and represented one of the best opportunities to leverage limited state funding with other sources of capital to carry out CI's statutory mission as intended by Public Act 98-203.

An SBIC is a privately-owned and operated equity fund that receives a license from the U.S. Small Business Administration ("SBA"). The license enables an SBIC to obtain federal funding for investment purposes on favorable terms. This "leverage" is available in amounts up to twice the SBIC's privately-raised capital. Recognizing the importance of leverage to the achievement of CI's statutory objectives without further state funding, the legislature, in Public Act 98-203, expressly authorized CI to participate in the creation of affiliated investment entities that would raise capital from sources other than the state. The relevant provisions of Public Act 98-203 were codified as a new subsection (36) of Section 32-34 granting CI the power to create affiliates in connection with capital initiatives, and as new subsections of Section 32-34 defining "capital initiative" and "affiliate". As with all provisions of CI's enabling legislation, these powers are to be broadly interpreted to effectuate CI's purposes. Conn. Gen. Stat. 32-44. Given the symmetry between the "Small Business" requirement for SBIC funding and CI's focus on emerging technology businesses, and in light of the difficulty in the capital markets of raising private equity for such purposes without the added advantage of federal leverage, CI determined that an SBIC presented a promising opportunity to further CI's public purposes in the manner envisioned by Public Act 98-203. CI was cognizant of its statutory mission to advance Connecticut interests and, notwithstanding the broader geographic scope proposed for the SBIC, intended to insure that SBIC investments within Connecticut were a multiple of CI's own funding. CI's outside counsel was consulted on this issue in 1999 and concluded that with proper safeguards, including minimum Connecticut presence requirements, limitations on capital calls on CI to insure benefits in Connecticut in excess of the CI funding, and special public purpose withdrawal rights, an investment fund such as an

SBIC could be structured in a way that would permit CI participation even though the fund's investments were not limited to Connecticut. In light of the Auditor's concerns in this regard, however, CI does not intend to invest in any such fund unless and until CI's authority to do so is clarified legislatively or otherwise.

CI's SBIC application received a "green light" from the SBA (few applications proceed this far), which represents an initial determination of eligibility for an SBIC license and usually means that the license will be issued in due course. The change in ownership percentages referred to in the Auditor's comments resulted from the normal process of give and take with the SBA staff during the processing of the application. Characterizing this as an attempt to "find ways around" the SBIC requirements gives a negative connotation to what was an entirely open process during which efforts were made by CI to satisfy SBA concerns about issues of "state control" so the SBA license could be issued. Those concerns as they related to the ownership percentages were expressed early in the SBIC process, and at a meeting of the board of directors of Next Generation Ventures LLC held on May 18, 2001, with all such owners present, the changes in ownership percentages were presented and approved. CI has provided a copy of the minutes of this meeting to the Auditors. While as noted by the Auditors the contract evidencing these ownership changes was signed later, giving that contract effect as of the date the changes were approved is not fairly characterized as "backdating" since it is a common and accepted practice for a contract to have an effective or "as of" date that reflects the date from which the parties intended the contract to be effective, which in this case was the date of the meeting at which all interested parties approved the change. In no event was the dating of the contract for the purpose of misleading the SBA, since there was an open and ongoing dialogue between CI and the SBA over this period relating to the ownership percentage issue and other SBA state control concerns. The fact that the license was not in fact issued after much hard work and effort was the result of a very late SBA change of mind (really a change in policy regarding applications involving state participants) that could not have been predicted and came as a surprise not only to CI but to its very experienced SBA counsel."

*Auditors' Concluding Comments:*

We are aware that CI has the authority to invest in such entities as those indicated in its response. However, CI does not have the authority to invest in entities outside of the State of Connecticut. We note that the proposed SBIC would have invested in such entities, and that the structure of the proposed SBIC did not include those necessary safeguards that CI identified in its response.

**Non-Compliance with Written Procedures - Requests for Proposals:**

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*Criteria:* CI's written procedures require that, wherever possible, any contract for personal services requiring an expenditure by the Corporation in excess of \$75,000 shall be awarded on the basis of a process of competitive negotiation where proposals are received from at least three qualified parties. CI's written procedures governing the purchase of real and personal property include similar requirements.

*Condition:* As part of a whistleblower matter concerning the Connecticut Clean Energy Fund that we investigated under Section 4-61dd of the General Statutes, we became aware of two instances in which expenditures exceeded \$75,000 and for which there were no bids or proposals received.

In one instance, CI hired a consultant for the CCEF to help put together a fuel cell program. The contractor was paid \$15,000 per month on a retainer basis, plus expenses. CI executed three separate consecutive contracts, each with a \$60,000 maximum, plus expenses. The contracts were effective August 1, 2001, through June 30, 2002, and the total payments made were \$186,392. CI violated its written procedures by splitting up the consultant's contracts so that each was below the \$75,000 threshold requiring competitive negotiation.

In the other instance, in June 2001, the CI Chairman of the Board, Arthur Diedrick, signed an agreement for the CCEF to purchase a fuel cell for \$1,250,000, without there having been any bids solicited or a Request for Proposals [RFP] issued. At the time the agreement was signed the CCEF had not determined a site for this fuel cell, and the Fund paid \$625,000 to the company before it was ultimately determined that it would be put at Yale University, as per its February 28, 2003 agreement with Yale. The final payment was made in the 2004 fiscal year.

We reported these matters to the Governor and other State Officials pursuant to Section 2-90 of the General Statutes, in a letter dated August 19, 2005.

*Effect:* CI did not comply with its written procedures that require a process of competitive negotiation where proposals are received from at least three qualified parties for expenditures exceeding \$75,000. In the instances cited above, significant amounts were committed and expended without knowing that the best prices for the products were obtained.

*Cause:* We did not determine the cause.

*Recommendation:* CI should adhere to its written procedures regarding expenditures by the Corporation that are in excess of \$75,000. (See Recommendation 3.)

*Agency Response:* “Subsequent to the instances cited in the audit, CI revised and updated its procedures for monitoring compliance with its contract procedures. Beginning in July 2002, the procedure, Internal Management of Consulting and Advisory Services (FIN-102), requires that all contracts are reviewed and monitored by the Finance Department for compliance with the CI’s approval procedures, internal management practices, and annual budget expense limits. Contractors with multiple contracts are also monitored to insure that the total amount paid to a single consultant does not exceed policy limits.”

**Contract Approvals:**

*Criteria:* CI’s internal control procedures include a requirement that the Executive Director approve all contracts that exceed \$10,000.

*Condition:* Our review disclosed two instances in which the Executive Director’s written approval was not obtained for contracts that exceeded \$10,000, and one payment of \$6,091 for which a contract supporting the payment could not be located. Our review also disclosed that CI’s independent auditor cited several instances in the 2004 fiscal year in which CI did not follow its contracting procedures, and in which CI processed payments for the Connecticut Clean Energy Fund that did not follow the contracting procedures.

*Effect:* Internal control is weakened when established written procedures are not followed.

*Cause:* We did not determine the cause.

*Recommendation:* CI should implement procedures to ensure that its written procedures pertaining to contract execution are followed. (See Recommendation 4.)

*Agency Response:* “The two instances cited had been verbally approved by the Executive Director. CI has since modified its’ approval procedure so that if the Executive Director is unavailable for a period of time to approve invoices, the Executive Director may delegate his/her authority to approve purchases to the VP of Finance and Administration in writing. The VP of Finance must then review all items with the Executive Director upon his/her return to the office and obtain approval from the Executive Director at that time.”

**Connecticut Clean Energy Fund Revenues:**

*Criteria:* A system of internal control over revenues should include procedures requiring that revenues be supported by documentation substantiating the accuracy and completeness of the amounts due compared to those that are

collected.

*Condition:* The Connecticut Clean Energy Fund receives monthly payments from two utility companies, representing charges assessed to end-users of electric services as mandated under Section 16-245n of the General Statutes, that currently aggregate over \$20,000,000 annually. During the audited period, documentation supporting the amounts paid by one of the companies consisted of only an assessment calculation, while the other company provided only a check. Therefore, it could not be determined from the documentation on file whether all of the required assessments were collected. CI does have a procedure in place to ensure that a payment from each company is received for each month.

*Effect:* There is reduced assurance that the Connecticut Clean Energy Fund received all of the revenue to which it was entitled.

*Cause:* CI did not request documentation from the utility companies to support each monthly payment that was made.

*Recommendation:* CI should institute procedures to ensure that it obtains adequate documentation supporting the revenue collected for the Connecticut Clean Energy Fund, and to enable CI to determine that the collected amounts represent all of the monies that the Connecticut Clean Energy Fund is due. Also, consideration should be given to reviewing prior years' payments to ensure that the Connecticut Clean Energy Fund received all of the revenue that it was statutorily required to receive. (See Recommendation 5.)

*Agency Response:* “Under Section 16-245n, subsection (b), of the Statutes, the DPUC is responsible for assessing the charge on end-users of electricity that is earmarked for the Connecticut Clean Energy Fund. The statutes do not give CI the authority to audit the utilities calculation of ratepayer contributions or to require the utilities to provide CI with supporting documentation for the monies sent to the Connecticut Clean Energy Fund. Such authority rests with the DPUC.

CI discussed this matter with the DPUC last year and was informed by the DPUC that the DPUC does review and audit the amount of ratepayer contributions the utilities collect and send to the Connecticut Clean Energy Fund. CI will request written verification from the DPUC of their review and audit of ratepayer contributions. CI will also request that the utilities send additional supporting documentation with their monthly payment.”

**Conflicting Statutory Reporting Provisions:**

*Criteria:* Section 32-47a of the General Statutes details the specific contents of annual reports that CI is required to submit, one of which shall be submitted by November 1<sup>st</sup> annually to the Commissioner of Economic and Community Development, the Auditors of Public Accounts and the joint standing committee of the General Assembly having cognizance of matters relating to the Department of Economic and Community Development, appropriations and capital bonding. Among the information required to be disclosed in that report is information concerning the gross revenues during each recipient’s most recent fiscal year.

Section 32-40, subsection (c), of the General Statutes provides that all financial information obtained by CI concerning any applicant or project shall not be regarded as public records.

*Condition:* CI’s reports issued in conformance with Section 32-47a of the General Statutes do not present the gross revenues during the recipient’s most recent fiscal year. Consistent with its reporting in the past, CI’s reports issued during the audited period presented a “Gross Revenue Analysis” which summarized only the number of entities falling within various ranges of gross revenues.

*Effect:* The Corporation did not disclose all of the information required under Section 32-47a of the General Statutes.

*Cause:* There are conflicting statutes regarding the disclosure of the revenue figures, and CI has taken the position that such information is confidential in accordance with Section 32-40, subsection (c).

*Recommendation:* CI should seek legislative clarification to resolve the apparent statutory conflict between Section 32-47a and 32-40, subsection (c), to ensure that all information is reported consistent with the legislative intent. (See Recommendation 6.)

*Agency Response:* “We agree. CI will consider seeking changes to the relevant General Statutes.”

**Statutory Responsibilities Codified Outside of Corresponding Chapter:**

*Criteria:* In order to more readily associate statutory responsibilities to the entity charged with carrying out those tasks, such duties are normally delineated in the Chapter(s) of the Statutes creating the entity.

*Condition:* Section 16-245n is located in Chapter 283 of the Statutes, which is devoted to matters affecting the Department of Public Utility Control (DPUC). Under Section 16-245n, subsection (b), the DPUC is responsible for assessing a charge on end-users of electricity that is

earmarked for the Renewable Energy Investment Fund (Connecticut Clean Energy Fund), which, under 16-245n, subsection (c), shall be administered by CI. There is currently no reference to the Connecticut Clean Energy Fund in Chapter 581 of the General Statutes, which is devoted to CI matters.

*Effect:* Chapter 581 of the General Statutes does not include all of CI's statutory responsibilities.

*Cause:* The current statutory structure reflects the original legislation.

*Recommendation:* CI should consider seeking changes to the relevant General Statutes to reflect its responsibilities for managing the Connecticut Clean Energy Fund as specified in Section 16-245n of the General Statutes. (See Recommendation 7.)

*Agency Response:* "We agree. CI will consider seeking changes to the relevant General Statutes."

## RECOMMENDATIONS

### *Status of Prior Audit Recommendations:*

Five recommendations were presented in our prior report. This report contains seven recommendations, three of which are restated from our prior report. The following is a summary of the prior recommendations and the action taken by CI.

- CI should establish a policy pertaining to the payment of severance payments. This recommendation has been resolved, as has CI created a severance payment policy.
- CI should implement procedures to comply with all of its legislated reporting requirements. Where questions exist as to the confidentiality of required information, the Corporation should seek legislative clarification to ensure that the legislative intent is met. CI has not sought legislative clarification pertaining to the confidentiality issue. This recommendation is being restated as Recommendation 6.
- CI should institute procedures to ensure that it obtains adequate documentation in a timely manner to support revenue of the Connecticut Clean Energy Fund, and to enable CI to prepare regular accountability reports. CI did not obtain documentation to support that the amounts received from utility companies were correct. This recommendation will be restated as Recommendation 5.
- Connecticut Innovations, Inc. should consider seeking changes to the relevant General Statutes to reflect its responsibilities for managing the Connecticut Clean Energy Fund, as specified in Section 16-245n of the General Statutes. This recommendation will be repeated as Recommendation 7.
- In conjunction with its independent auditors, Connecticut Innovations, Inc. should exercise greater care in identifying organizations that meet the criteria of related parties. This recommendation has been resolved.

*Current Audit Recommendations:*

- 1. CI should refrain from allowing its employees to benefit from employment with any portfolio company that it has created.**

Comment:

A former CI employee was permitted to benefit significantly from a CI created company that the former employee was involved in establishing.

- 2. CI should pursue only investment opportunities that are clearly within its statutory authority.**

Comment:

CI spent considerable time and effort pursuing the formation of a Small Business Investment Company, even though the licensing agency expressed concerns early in the application process that should have been enough for CI to conclude that this was not something that it was permitted to participate in.

- 3. CI should adhere to its written procedures regarding expenditures by the Corporation that are in excess of \$75,000.**

Comment:

As part of a whistleblower matter concerning the Connecticut Clean Energy Fund that we investigated under Section 4-61dd of the General Statutes, we became aware of two instances in which expenditures exceeded \$75,000 and for which there were no bids or proposals received. In one instance, contracts were split so that each would be under the \$75,000 threshold, and, in the other, a commitment to purchase a fuel cell for \$1,250,000 was executed without soliciting bids or issuing a Request for Proposals.

- 4. CI should implement procedures to ensure that its written procedures pertaining to contract execution are followed.**

Comment:

Our review disclosed two instances in which the Executive Director's written approval was not obtained for contracts that exceeded \$10,000, and one payment of \$6,091 for which a contract supporting the payment could not be located. In addition, CI's independent auditor cited several instances in the 2004 fiscal year in which CI did not follow its contracting procedures, and several instances in which CI processed payments for the Connecticut Clean Energy Fund that did not follow the contracting procedures.

- 5. CI should institute procedures to ensure that it obtains adequate documentation**

**supporting the revenue collected for the Connecticut Clean Energy Fund, and to enable CI to determine that the collected amounts represent all of the monies that the Connecticut Clean Energy Fund is due. Also, consideration should be given to reviewing prior years' collections to ensure that the Connecticut Clean Energy Fund received all of the revenue that it was statutorily required to receive.**

Comment:

The Connecticut Clean Energy Fund receives monthly payments from two utility companies that currently aggregate over \$20,000,000 annually. During the audited period, documentation supporting the amounts paid by one of the companies consisted of only an assessment calculation, while the other company provided only a check.

- 6. CI should seek legislative clarification to resolve the apparent statutory conflict between Section 32-47a and 32-40, subsection (c), to ensure that all information is reported consistent with the legislative intent.**

Comment:

The Corporation did not disclose all of the information required under Section 32-47a of the General Statutes because certain of that information is considered confidential under Section 32-40, subsection (c).

- 7. CI should consider seeking changes to the relevant General Statutes to reflect its responsibilities for managing the Connecticut Clean Energy Fund, as specified in Section 16-245n of the General Statutes.**

Comment:

While CI is responsible for the administration of the Fund, it is not mentioned in CI's authorizing legislation.

## **INDEPENDENT AUDITORS' CERTIFICATION**

As required by Section 2-90 and Section 1-122 of the General Statutes, we have conducted an audit of Connecticut Innovations, Incorporated activities for the fiscal year ended June 30, 2004. This audit was primarily limited to performing tests of the Corporation's compliance with certain provisions of laws, regulations, contracts and grants, including but not limited to a determination of whether the Corporation has complied with its regulations concerning affirmative action, personnel practices, the purchase of goods and services, the use of surplus funds and the distribution of loans, grants and other financial resources, and to understanding and evaluating the effectiveness of the Corporation's internal control policies and procedures for ensuring that the provisions of certain laws, regulations, contracts and grants applicable to the Corporation are complied with. The financial statement audit of the Corporation, for the fiscal year indicated above, was conducted by the Corporation's independent public accountants.

We conducted our audit in accordance with the requirements of Section 2-90 and Section 1-122 of the General Statutes. In doing so, we planned and performed the audit to obtain reasonable assurance about whether the Corporation complied in all material respects with the provisions of certain laws, regulations, contracts and grants and to obtain a sufficient understanding of internal control to plan the audit and determine the nature, timing and extent of tests to be performed during the conduct of the audit.

### **Compliance**

Compliance with the requirements of laws, regulations, contracts and grants applicable to Connecticut Innovations, Incorporated is the responsibility of the Corporation's management.

As part of obtaining reasonable assurance about whether the Corporation complied with laws, regulations, contracts and grants, noncompliance with which could result in significant unauthorized, illegal, irregular or unsafe transactions or could have a direct and material effect on the results of the Authority's financial operations for the fiscal year ended June 30, 2004, we performed tests of its compliance with certain provisions of laws, regulations, contracts and grants, including but not limited to the following areas:

- Affirmative action
- Personnel practices
- Purchase of goods and services
- Use of surplus funds
- Distribution of loans, grants and other financial resources

Our examination included reviewing all or a representative sample of the Corporation's activities in those areas and performing such other procedures as we considered necessary in the circumstances. The results of our tests disclosed the following instances of non-compliance, which are further described in the accompanying "Condition of Records" and "Recommendations" sections of this report: the lack of competitive bidding pertaining to certain expenditures in excess of \$75,000, as required under CI's written procedures and instances of non-compliance with its contract approval procedures.

## **Internal Control**

The management of Connecticut Innovations, Incorporated is responsible for establishing and maintaining effective internal control over its financial operations and compliance with the requirements of laws, regulations, contracts and grants applicable to the Corporation. In planning and performing our audit, we considered the Corporation's internal control over its financial operations and its compliance with requirements that could have a material or significant effect on the Corporation's financial operations in order to determine our auditing procedures for the purpose of evaluating the Corporation's financial operations and compliance with certain provisions of laws, regulations, contracts and grants, and not to provide assurance on the internal control over those control objectives. Our consideration of internal control included, but was not limited to, the following areas:

- Affirmative action
- Personnel practices
- Purchase of goods and services
- Use of surplus funds
- Distribution of loans, grants and other financial resources

However, we noted certain matters involving the internal control over CI's financial operations, safeguarding of assets, and/or compliance that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of internal control over CI's financial operations, safeguarding of assets, and/or compliance that, in our judgment, could adversely affect CI's ability to properly record, process, summarize and report financial data consistent with management's authorization, safeguard assets, and/or comply with certain provisions of laws, regulations, contracts, and grants. We believe the following findings represent reportable conditions. We believe our findings titled "CI Created Portfolio Companies and Conflict of Interest Matters" and "Investment Opportunity Outside of CI's Statutory Authority," as well as the lack of competitive bidding pertaining to certain expenditures in excess of \$75,000, represent weaknesses in the control environment that are reportable conditions.

A material or significant weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that noncompliance with certain provisions of laws, regulations, contracts, and grants or the requirements to safeguard assets that would be material in relation to the Agency's financial operations or noncompliance which could result in significant unauthorized, illegal, irregular or unsafe transactions to the Agency being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over CI's financial operations and over compliance would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material or significant weaknesses. However, we believe that none of the reportable conditions described above is a material or significant weakness.

We also noted other matters involving internal control over the Agency's financial operations and over compliance which are described in the accompanying "Condition of Records" and "Recommendations" section(s) of this report.

This report is intended for the information of the Governor, the State Comptroller, the

Appropriations Committee of the General Assembly and the Legislative Committee on Program Review and Investigations. However, this report is a matter of public record and its distribution is not limited. Users of this report should be aware that our audit does not provide a legal determination of Connecticut Innovations, Incorporated's compliance with the provisions of the laws, regulations, contracts and grants included within the scope of this audit.

**CONCLUSION**

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 DiDomizio  
Principal Auditor

Approved:

Kevin P. Johnston  
Auditor of Public Accounts

Robert G. Jaekle  
Auditor of Public Accounts