STATE OF
NORTH CAROLINA

SPECIAL REVIEW

NORTH CAROLINA TECHNOLOGICAL DEVELOPMENT AUTHORITY, INC.

DECEMBER 2001

OFFICE OF THE STATE AUDITOR

RALPH CAMPBELL, JR.

STATE AUDITOR

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Ralph Campbell, Jr.
State Auditor

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LETTER OF TRANSMITTAL

December 13, 2001

The Honorable Michael F. Easley, Governor
Members of the North Carolina General Assembly
Mr. James T. Fain III, Secretary
North Carolina Department of Commerce
Mr. John P. McConnell, Chairman of the Board of Directors
North Carolina Technological Development Authority, Inc.

Ladies and Gentlemen:

Pursuant to General Statute §147-64.6(c)(16), we have completed our special review into allegations concerning the activities of the North Carolina Technological Development Authority, Inc. The results of our review, along with recommendations for corrective actions, are contained in this report.

General Statute §147-64.6(c)(12) requires the State Auditor to provide the Governor, the Attorney General, and other appropriate officials with written notice of apparent instances of violations of penal statutes or apparent instances of malfeasance, misfeasance, or nonfeasance by an officer or employee. In accordance with that mandate, and our standard operating practice, we are providing copies of this special review to the Governor, the Attorney General and other appropriate officials.

Respectfully submitted,

Ralph Campbell, Jr.

Ralph Campbell, Jr., CFE
State Auditor

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INTRODUCTION

In July 2001, the State Auditor's Office received an allegation that checks were issued to the president of the North Carolina Technological Development Authority, Inc. (NCTDA) without supporting documentation. In August 2001, we began a special review of this allegation.

We used the following procedures to conduct this special review:

- Examination of NCTDA documents and records.
- Examination of North Carolina General Statutes and NCTDA policies and procedures.
- Interviews with employees of NCTDA.
- Interviews with board members of NCTDA.
- Interviews with individuals external to NCTDA.

This report presents the results of our special review. The review was conducted pursuant to G.S. § 147-64.6(c)(16) rather than a financial audit. An independent public accounting firm performs an annual financial audit of NCTDA.

Background /Funding

The North Carolina Technological Development Authority, Inc. (NCTDA) is a private non-profit economic development corporation. For the fiscal year ended September 30, 2000, the North Carolina General Assembly appropriated $4,000,000 to support the programs administered by NCTDA. Other revenue during that same period included grants from state and federal government agencies as well as investment and rental income. Total unrestricted revenues for the fiscal year ended September 30, 2000 were $8,961,649. Total unrestricted expenses for the fiscal year ended September 30, 2000 were $5,733,481. The NCTDA mission is to support the formation and development of entrepreneurial, innovation-oriented business ventures in North Carolina.

To achieve this mission, NCTDA provides capital to emerging small businesses through direct investments, loans and grants. Many of the investments, loans and grants are made to businesses located in regional business incubators throughout North Carolina. Other investments, loans and grants go to businesses outside the business incubator system. NCTDA also administers an Intermediary Relending Program for the U.S. Department of Agriculture to provide financing to emerging rural companies in North Carolina.

NCTDA began operating in 1983 as an agency of the State of North Carolina. During its 1991 session, the North Carolina General Assembly authorized the creation of a private nonprofit corporation and the transfer of the assets, activities and name of NCTDA into the new corporation. The incorporation and transfer were effective September 1, 1991. The legislation authorizing the transfer specified only that the assets be utilized to promote the aforementioned activities. The only formal restriction provided that certain property and equipment would revert to the State if not utilized for such activities.

Facilities

NCTDA maintains administrative offices in the First Flight Venture Center (FFVC) in Research Triangle Park, North Carolina. NCTDA leases office and laboratory space to small technology-oriented businesses at the Entrepreneurial Development Center at North Carolina State University, and at the NCTDA Lifescience Center and FFVC in Research Triangle Park, North Carolina.

Board of Directors

A seventeen-member board of directors is responsible for the affairs of NCTDA. The board of directors elects its members from a slate of candidates set forth by a nominating committee. The board of directors meets at least four times a year including an annual meeting.

Organizational Structure

NCTDA currently has thirteen employees. Executive positions include the position of president, chief financial officer, director of operations, director of investments, and director of technology transfer. Other professional positions include the director of human resources, facilities manager, property manager, information systems manager and manager of rural initiatives. There are also three positions dedicated to administrative support.

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1. NCTDA LOANED THE PRESIDENT $32,354 TO PARTICIPATE IN THE FIRST FLIGHT VENTURE FUND (FFVF) WITHOUT THE FORMAL APPROVAL OF THE BOARD OF DIRECTORS.

The current president of NCTDA has served in that capacity since January 2000. Prior to January 2000, he was the Investment Fund Manager for three years. The president's total compensation is comprised of salary, bonuses, and a vested interest in the net profits of the First Flight Venture Fund (FFVF). This is a fund that provides venture capital to emerging technology businesses in North Carolina.

On January 1, 2000, NCTDA "sold" the president a one percent ownership interest in the total value of the FFVF. At that time the total value was $3,405,715. The president's cost of one percent ownership was $34,057 and this was to be paid by him prior to September 30, 2000. The president signed a promissory note on January 1, 2000, documenting that he owed NCTDA $32,354 and on September 28, 2000, wrote NCTDA a personal check for the remaining $1,703.

The board minutes do not reflect approval of this loan by the NCTDA board of directors. Several members of the board stated they were not aware of the loan. According to NCTDA bylaws, "No loans shall be contracted on behalf of the Corporation and no indebtedness shall be issued in its name, unless and except as authorized by the board of directors." In addition, NCGS § 55A-8-32 and NCGS § 55A-8-31(a)(1) specify that loans made to directors or officers of a nonprofit corporation require the approval of its board of directors.

In addition, the personal check written by the president to NCTDA on September 28, 2000, was not deposited until almost seven months later on April 26, 2001.

On April 3, 2001, NCTDA paid the president $43,346.67 in profit distributions from the FFVF. After the distributions, the president paid off the loan and his personal check was deposited.

Note

The North Carolina General Assembly passed Session Law 2001-424, Section 20.8 earlier this year. This law provides that NCTDA must "Work with the Attorney General's Office to craft a legal agreement that specifies the manner in which any profits from investments made with State funds shall be shared with the State"(see Appendix).

RECOMMENDATION

The NCTDA board of directors should approve all material transactions between NCTDA and the president of NCTDA before the transactions are executed. This should be done to ensure compliance with NCTDA bylaws and the statutory requirements noted above. In addition, NCTDA should implement policies to ensure all receipts are deposited in a timely manner.

2. NCTDA EXECUTIVE COMPENSATION APPEARS EXCESSIVE COMPARED TO OTHER ORGANZATIONS FUNDED PRIMARILY THROUGH STATE APPROPRIATIONS.

During our review of employee compensation, we noted that five of the thirteen NCTDA employees received compensation significantly above what we expected for state funded nonprofit organizations or state agencies.

For example, the president began his tenure as president of NCTDA at an annual salary of $100,000 per year on January 1, 2000. On March 9, 2000, (three months later) he received a performance bonus of $36,000 even though his initial employment contract stated that his bonus would not exceed $20,000 per year. On July 21, 2000, he received an additional $20,000 bonus. On January 1, 2001, his annual salary was adjusted to $127,000 per year. On January 31, 2001, he received another $10,000 bonus. During his first two years as president of NCTDA, he received a $27,000 salary increase, $66,000 in bonuses and is eligible for a $40,000 bonus in 2001. In addition, he received a profit distribution of $43,346.67 on April 3, 2001. The president's total compensation for 2001 will be at least $220,346 if he receives the $40,000 bonus the board approved for the year.

The chief financial officer (CFO) began his employment with NCTDA as an independent consultant in February 2000. From February 2000 until December 2000, he was paid $6,667 per month for a total of $73,337 in 2000. On January 1, 2001, he became a full-time employee of NCTDA. On January 11, 2001, the CFO was paid a $10,000 bonus for his work as a consultant to the NCTDA during the preceding 11 months. His annual salary as CFO of NCTDA is $108,000 per year. He is also eligible for a first year bonus of $42,000 to be paid at the discretion of the president. In addition to salary and bonus, he is eligible to participate in the profits of the FFVF through a 2% “carried interest”.

On June 1, 2000, the managing director of the FFVF was hired at an annual salary of $90,000 per year. He is eligible for performance bonuses at the discretion of NCTDA’s president. He is also eligible to participate in the profits of the FFVF through a 3% “carried interest”.

On September 1, 2000, the director of operations for NCTDA was hired at an annual salary of $108,000 per year. He is also eligible for performance bonuses at the discretion of NCTDA’s president.

On October 1, 2000, the director of technology transfer was hired at an annual salary of $90,000 per year and received a $5,000 signing bonus. He is eligible for another $10,000 at the end of his first six months of employment. He is also eligible to participate in the profits of the FFVF according to NCTDA’s director of human resources.

In order to put the executive compensation outlined above in prospective, we compared the NCTDA salaries to the salaries of other organizations funded primarily by state appropriations.

Position	2001 Potential Compensation
President of **NCTDA**	$220,346*
President and CEO of the NC Biotechnology Center	$197,964
University Chancellors (average)	$187,956
Chief Financial Officer **NCTDA**	$160,000*
Governor of North Carolina	$118,430
Director of Operations **NCTDA**	$108,000
NC Council of State Members	$105,236
NC Cabinet Secretaries	$102,119
Director of Technology Transfer **NCTDA**	$100,000*
Executive Director NC Agricultural Finance Authority	$90,470
Manager First Flight Venture Fund **NCTDA**	$90,000

* Includes bonus for 2001. President's compensation includes profit distribution from FFVF.

The president of NCTDA is capable of earning more than the president and CEO of the NC Biotechnology Center, the average university chancellor, the Governor, council of state members, and executive director of the NC Agricultural Finance Authority. The university chancellors, Governor, council of state members and cabinet secretaries all have large organizations to manage in the form of employees and money. NCTDA has only thirteen employees and a budget that ranges between $3 and $9 million on average.

For most of the past year, NCTDA has employed a part-time controller on a contractual basis and a part-time accounting clerk through a temporary service to perform its day-to-day accounting and financial reporting functions. The payroll for the NCTDA is contracted to an outside firm. Independent CPA firms prepare NCTDA's annual federal and state tax returns (990 and a 1065 for the FFVF). In addition, according to the CFO, NCTDA was planning to contract most of its day-to-day accounting and financial reporting functions to an outside accounting and financial services firm beginning in October 2001.

Our salary research indicates that for an organization that employs less than 20 people, with only one or two full-time equivalent employees performing accounting functions, and annual revenue less than $5 million, the median compensation for a CFO is $62,000 per year. The current CFO salary is $108,000 plus the possibility to earn $42,000 in bonuses.

The NCTDA Statement of Activities for the eighteen-month period ended September 30, 2000, indicates that salaries and employee benefits totaled $1,943,764 (13 employees) which was 33% of the unrestricted expenses and losses before depreciation. The total revenue during the time period was $ 8,961,649 of which $ 4,000,000 was appropriated by the North Carolina General Assembly.

RECOMMENDATION

We recommend the board of directors carefully consider the executive compensation structure of the organization. The board should review the specific responsibilities of each position, the size of the organization, and the annual budget and make adjustments to compensation as it considers necessary. This analysis and study of compensation should be undertaken by a broad representation of the board of directors, including members of the audit and finance committee and the personnel committee.

3. NCTDA CONTRACTED WITH THE CFO's FORMER BUSINESS PARTNER AND BROTHER.

Business Partner

In May 2000, NCTDA paid an accountant $2,500 for 30 hours of time spent on reviewing construction financing for expanding the First Flight Venture Center. From July 11, 2000 through February 28, 2001, NCTDA paid the accountant's firm $34,387.50 for providing a temporary employee to NCTDA. Based on documents on file with the NC Secretary of State, the CFO and accountant were business associates from December 13, 2000 to May 08, 2001. Based on loan documents on file with the City of Durham, the temporary employee provided by the accountant to work at NCTDA was also an employee of the CFO from March 2000 through December 2000.

The accountant was paid at a rate of $70 per hour to provide the temporary accounting employee to NCTDA. NCTDA has hired other temporary accounting personnel for approximately $27 per hour to perform similar functions.

Section 9 of the NCTDA by-laws addresses conflicts of interest. This section states, "any action on the part of a director of the corporation which results in a voidable transaction pursuant to NCGS 55A-8-31 will also be considered a prohibited and impermissible conflict of interest. This prohibition shall apply to actions of employees of the corporation as well."

NCGS § 55A-8-31 states:

(a) A conflict of interest transaction is a transaction with the corporation in which a director of the corporation has a direct or indirect interest.

(b) For purposes of this section, a director of the corporation has an indirect interest in a transaction if:

(1) Another entity in which he has a material financial interest or in which he is a general partner is a party to the transaction.

Brother

From September 2000 to August 2001, NCTDA paid the CFO's brother $15,060 at a rate of $50 per hour to mow grass and perform other landscaping functions such as raking leaves, spreading grass seed and trimming hedges. Prior to September 2000, landscaping functions such as grass mowing were performed by a part-time NCTDA employee who was paid at the rate of $10 per hour.

RECOMMENDATION

We recommend that any contract involving a relative or business associate of an employee or director, undergo a strict evaluation by the board of directors with respect to the need for the product or service, the fees involved and the perception associated with transactions involving related parties.

4. NCTDA DOES NOT HAVE WRITTEN POLICIES CONTROLLING TRAVEL AND ENTERTAINMENT EXPENSES.

We examined the travel and entertainment expenses for NCTDA employees and its board of directors for the periods October 1, 1999 through September 30, 2000 and October 1, 2000 through August 21, 2001. The expenses for the board of directors totaled $41,257 and $68,258, respectively, during the two years. The employee expenses totaled $71,233 and $46,249, respectively, during the two years. The board meets four times a year and committee meetings are held in the interim. In addition, various board members travel with NCTDA staff to different national meetings during the year. The current staff consists of thirteen employees.

The following are some examples of travel, entertainment and operational expenses that are inappropriate or questionable.

- The board had dinner at Vinnie's Steakhouse in Raleigh on February 10, 2000, at a cost of $1,994.25 plus a $399.00 tip for a total of $2,393.05.
- In February 2001, the board had a meal at the Deerpark restaurant in Asheville for $1,480.00.
- In November 2000, the president of NCTDA and two board members attended a convention in Honolulu, Hawaii at a cost in excess of $12,000.
- On November 7, 2000, the president of NCTDA paid $335.36 for a meal and beverages at a restaurant in Honolulu, Hawaii. There was no indication on the documentation as to who was present other than the president.
- On October 20, 1999, NCTDA paid the Radisson-Governor's Inn, Research Triangle Park $1,148.85 for rooms that were reserved for a board committee meeting. The meeting was cancelled but the staff and board failed to cancel the rooms which were guaranteed.

- On October 27, 2000, a staff member ate dinner at Sullivan's in Raleigh for $65.21 to determine if the restaurant was acceptable for a future board dinner.
- On February 12, 2001, a dinner meeting at 42nd Street Oyster Bar was paid for by the president at a cost of $429.59. The documentation showed dinner meeting – General Assembly.
- NCTDA routinely pays for staff meals. The number of staff at these meals range from one person to every staff member. On October 11, 2000, a staff lunch event cost $1,328.51. An employee dinner meeting on December 19, 2000, at "Its Prime Only" cost $1,992.67. Employee lunch meetings at the Pizza Hut on April 17, 2000 and July 24, 2000, cost $171.21 and $132.35, respectively. In addition, NCTDA will occasionally pay for luncheons for the tenants that rent space in NCTDA building. A tenants' luncheon occurred on March 5,2001 at the Pizza Hut at a cost of $361.00. According to the president of NCTDA, meals were only reimbursed when someone other than a staff person was also present. However, the staff we talked with were not aware of this policy. The policy is not in writing.
- A refrigerator was purchased on May 10, 2000 for $236.13. According to the receipt, the refrigerator was purchased for the General Assembly.
- On October 24, 2000, a boater's photo camera was purchased at a cost of $212.00 and given to the president of NCTDA for Boss's Day.

We asked the president of NCTDA to explain why the travel and entertainment expenses for the board were so high. He stated that the board was made up of important people who served on the board without pay. Therefore, he thought it was justified to pay for the board members to fly to meetings, stay at the best places, and eat at the finer restaurants.

Although NCTDA is a private nonprofit entity, it receives a large percentage (70% in 1999 and 45% in 2000) of its funds for operations from state appropriations. Along with the acceptance of state appropriations is a fiduciary responsibility to expend these funds wisely, particularly during the budget shortfall experienced this past fiscal year. Based on our review of NCTDA's expenditures, written policies governing travel, entertainment, and operational expenses would help control costs.

RECOMMENDATION

We recommend NCTDA develop a policy which provides guidelines on acceptable travel and entertainment expenses. The policy should also include what is acceptable for the expenditures of funds for general operations. The policy should be approved by the board of directors and given to each member of NCTDA's staff.

5. THE NCTDA BOARD OF DIRECTORS IS NOT FULLY INFORMED OF FINANCIAL TRANSACTIONS.

Our interviews with NCTDA board members revealed some concerns that we identified during our review. Some of these concerns had been discussed at previous board meetings. Some board members expressed concern that the organization had become a mechanism for a few people to substantially profit if funds were invested in companies that would eventually sell stock publicly. These profits currently are shared by NCTDA and the president and could be shared with other employees in the future.

Six of the ten board members contacted did not know that NCTDA had loaned the president $32,354 to invest in the FFVF. This loan was made with the knowledge of the chairman of the board at that time and did not have to be repaid until stock was sold and the president received his share of the distribution (refer to finding 1).

Six of the ten board members contacted were not aware of the bonuses that were approved by the president for some members of his management team. Four board members expressed concern over the amount of salaries being paid to staff members.

In addition, it appears that the audit and finance committee of the board is currently not involved in the decisions regarding the expenditure of funds for consulting contracts, and distribution of profits to the president.

RECOMMENDATION

We recommend NCTDA management keep the board informed on all aspects of NCTDA's operations and that the board be provided detailed information concerning expenditure of funds.

6. NCTDA EXPENDED $549,726 FOR LOBBYING AND CONSULTING EXPENSES DURING A TWO-YEAR PERIOD.

NCTDA hired a lobbyist/consultant to assist in obtaining state appropriations and federal funding for its operations. An examination of lobbying and consultant contracts between NCTDA and the lobbyist/consultant raised questions relative to the amount paid to him.

In the fiscal year ended September 30, 2000, the lobbyist/consultant was paid $279,207 in fees and expenses. NCTDA received $3,500,000 in state appropriations and $215,516 in federal funding for that period. For the fiscal year ended September 2001, the lobbyist/consultant was paid $270,519 in fees and expenses. NCTDA received $3,500,000 in state appropriations and $675,000 in federal funding for that period. The state has approved appropriations to NCTDA for the current year in the amount of $1,600,000. The lobbyist has entered into the following contracts with NCTDA for the current fiscal year:

- A two-year state consulting contract for $90,000 per year and $25,000 per year in annual expenses.
- A two-year lobbying contract for $50,000 per year and $35,000 in annual expenses.
- A two-year federal consultant contract for $10,000 per year and $35,000 in annual expenses.

The total of these contracts per year is $245,000 in compensation and expenses. These contracts supercede the contracts that were already approved for the 2000-2001 fiscal year. These contracts did not increase the lobbying fees but did increase the allowance for expenses, particularly the federal consultant contract that pays $35,000 per year in expenses on a $10,000 per year compensation.

According to the president of NCTDA, the lobbying and consulting contracts are necessary to ensure state funding for NCTDA.

In our opinion, NCTDA is paying an excessive amount for lobbying and consulting fees and expenses. The mission of NCTDA is to create jobs and wealth throughout North Carolina by supporting the formation and success of the state's entrepreneurial, innovation-oriented businesses.

RECOMMENDATION

We recommend the NCTDA board of directors evaluate the benefits received from such a large expenditure for lobbying and consulting. We also recommend the North Carolina General Assembly determine the merits of providing state appropriations to an organization that expends approximately 8% of these appropriations on a lobbyist to assist the organization in obtaining the appropriation.

CONCLUSION

The North Carolina General Assembly funds NCTDA to support the formation and development of entrepreneurial, innovation-oriented business ventures, leading ultimately to the creation of jobs in North Carolina. In our opinion, allowing the president of NCTDA and certain members of its small staff to have ownership interest and profit participation in venture capital investments could conflict with legislative intent. The opportunity for personal gain could encourage NCTDA to invest only in those companies that have the greatest potential for going public and providing the president and certain staff members with a profit. Job creation and technology innovation, for example, may take a backseat to pure profitability.

In addition, the amount expended for salaries, bonuses, travel and entertainment for staff and board members, combined with gains on investments, raises questions as to the continued need for state appropriations especially during such difficult economic times. We encourage the North Carolina General Assembly to examine the need to provide state appropriations to an organization that has not demonstrated prudence in its spending of state funds.

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STATEMENT OF QUESTIONED COSTS

The following schedule represents a quantification of the items examined during our special review. We cannot completely quantify the tangible benefits or detriment, if any, to NCTDA resulting from the findings of our review. We are simply noting areas where managerial oversight should be enhanced, or where, in our judgment, questionable activities or practices occurred.

1. FFVF Distributions to President in 2001	$ 43,347
2. Salaries and Bonuses for Senior Management Positions in 2001	634,999
3. Disbursements To Parties Related to CFO (Jan. ’00 – Aug ’01)	51,948
4. Travel and Entertainment Expenses (Oct. ’99 – Aug. ’01)	226,997
5. Lobbying Expenses (Oct. ’99 – Sept. ’01)	549,726
	$ 1,507,017

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Session Law 2001-424:

BIOTECHNOLOGY CENTER/TECHNOLOGICAL DEVELOPMENT AUTHORITY, INC., PROFIT SHARING WITH STATE

SECTION 20.8.(a) Prior to receiving any General Fund disbursements for the 2001-2003 biennium, the North Carolina Biotechnology Center (hereinafter Center) and the North Carolina Technological Development Authority, Inc., (hereinafter Authority) must each enter into a memorandum of understanding with the Attorney General's Office in which they commit to do all of the following:

(1) Work with the Attorney General's Office to craft a legal agreement that specifies the manner in which any profits from investments made with State funds shall be shared with the State.

(2) Negotiate the terms of the legal agreement in good faith.

(3) Submit the proposed legal agreement to the Joint Legislative Commission on Governmental Operations for review by January 15, 2002.

(4) Execute the legal agreement no later than 30 days after it is presented to the Joint Legislative Commission on Governmental Operations.

SECTION 20.8.(b) If the Center or Authority fails to execute the legal agreement as provided in subdivision (a)(4) of this section, all disbursements to the Center or Authority shall be suspended until the legal agreement has been executed.

SECTION 20.8.(c) The Attorney General's Office shall consult with the Fiscal Research Division in crafting the memorandum of understanding and the legal agreement described in subsection (a) of this section.

SECTION 20.8.(d) The Center and the Authority shall submit a copy of the memorandum of understanding to the Fiscal Research Division prior to receiving any General Fund disbursements for the 2001-2003 biennium and shall submit a copy of the proposed legal agreement to the Division by January 15, 2002.

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STATE AUDITOR'S NOTE TO NCTDA'S RESPONSE

NCTDA issued the following response to our Special Review on December 13, 2001. The assertions in the response require a reply. After carefully reviewing the response, the Office of the State Auditor stands by the findings and recommendations made in this report. The response has statements or implications that we find misleading, confusing, and evasive.

For example, the response to Finding No. 1 states that NCTDA did not make a loan to the president. The information on file with NCTDA reflects that the president signed a promissory note to First Flight Venture Fund, but the checks he wrote to discharge the note were made payable to NCTDA. It also should be noted that NCTDA owns 99% of First Flight Venture Fund and its transactions are processed through NCTDA's bank accounts.

The response to Finding No. 2 on the president's compensation, notes that the president has agreed to forego a $40,000 bonus this year. However, we find that the response falls short of full disclosure by failing to mention that the NCTDA board authorized another loan of up to $42,000 for the president to assist him with his personal income tax liability incurred due to distributions he received from First Flight Venture Fund. A loan of $40,000 was issued to the president on October 1, 2001. All of these transactions occurred after the completion of our investigative fieldwork.

The purpose of this special review was to determine if NCTDA had expended state funds in a prudent and reasonable manner. As noted in the response, the original allegation was not substantiated, however we found a number of issues regarding their stewardship of state funds as outlined in this report.

The response from NCDTA included the following attachments:

- Letters from PricewaterhouseCoopers, LLP
- NCTDA Impact Analysis
- December 1999 TDA Board Minutes

Due to the volume of the second and third attachments, they are not included but may be obtained from the State Auditor's Office upon request.

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Response from NCTDA Board of Directors

MEMORANDUM

TO:	Ralph Campbell, Jr., CFE North Carolina State Auditor
FROM:	John P. McConnell Chairman, Board of Directors North Carolina Technological Development Authority, Inc.
DATE:	December 13, 2001
RE:	Special Review of North Carolina Technological Development Authority, Inc. by Office of North Carolina State Auditor Response to "DRAFT REPORT"
ATTACHMENTS:	1. Letter from PricewaterhouseCoopers, LLP 2. NCTDA Impact Analysis 3. December 1999 TDA Board Minutes

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This memorandum is to thank you for the benefit of your findings and for the opportunity to review the November 2001 draft report issued by your office. We are pleased that the original allegations leading to the review by your office that "checks were issued to the president …without supporting documentation" were disproved by your review. While this original allegation was found baseless, it nevertheless gave us the benefit of much good advice from your staff.

The Board has moved quickly to address other concerns that you have brought to our attention regarding the activities of the TDA. Additionally, this document and the attachments hereto, provide responses and comments for clarification that we request be carefully considered and incorporated into the final report on TDA.

An executive summary is offered with brief responses followed by a background section with more detailed comments. In each section, the applicable finding contained in the draft report of the State Auditor precedes TDA's comments and responses. In addition, a letter with observations from TDA's independent outside auditors, PricewaterhouseCoopers, LLP, is enclosed along with an analysis of TDA's economic development impacts.

After reviewing our response please contact me should you have any questions that require further clarification.

A. EXECUTIVE SUMMARY

1. TDA loaned the [TDA] President $32,354 to participate in the First Flight Venture Fund without the formal approval of the [TDA] Board of Directors.

Response:
The Board of Directors offered the President an employment contract to serve as the President and CEO of TDA and the Manager of the First Flight Venture Fund, LLC (FFVF). In capitalizing the FFVF the President, supervised by a Board-delegated committee was allowed to pay for his share in part, by signing a promissory note on which he agreed to pay a market rate of interest. This is a standard transaction for any venture capital operation. It is acknowledged that some Board members not serving on that committee were not able to answer questions about the details of this transaction and that there is a need for improved communications across the full Board. During a meeting on December 7, 2001 the full Board reviewed and unanimously ratified the establishment of FFVF, its Operating Agreement and the subject transactions thereof.

2. TDA executive compensation appears excessive compared to other organizations funded primarily through state appropriations.

Response:
TDA provides competitive salaries that are performance-based and commensurate with the responsibilities of each position. The comparison to other organizations funded primarily through state appropriations is an inappropriate comparison given the unique nature of TDA. Salaries and expenses in the Board-approved budget for fiscal year 2002 are 12% of fund sources and 20.9% of revenue. For the second year in a row, TDA's actual salaries expense as reflected in the audited financial statements for the respective fiscal years ended September 30, were below the Board-approved budget amount. The report states that the President's salary is $220,346. The actual income for the President of the TDA for 2001 is $144,187 of which $127,000 is base salary. The President has informed the Board that he will waive the $40,000 bonus payable per his contract.

3. TDA contracted with CFO's brother and CFO's former business partner.

Response:
It is true that TDA contracted with the CFO's brother and with the CFO's former business partner. The CFO is no longer employed by TDA. While no conflict of interest existed, all contractual relationships with the former CFO's brother and with the former CFO's former business partner have been terminated. TDA will review its conflict of interest policies and ensure that staff is well trained on these matters.

4. TDA does not have written policies controlling travel and entertainment expenses.

Response:
TDA has a written policy controlling travel and entertainment expenses, and has had since the early 1990's. Further, the said policy was reviewed and updated by the Board in 2001. Regrettably the policy does not cover all the issues raised by the State Auditor and the Board of Directors has directed the Audit and Finance Committee to review and tighten these policies.

5. TDA expended $549,726 for lobbying and consulting expenses during a two-year period.

Response:
The lobbying and consulting expenditures include a broad array of work by TDA, including work on long range funding sources to enable the organization to become less dependent on state appropriations. Services from McClees Consulting include both lobbying and consulting. The lobbying fees and expenses of $187,347 are 2.4% of the state appropriation for the period analyzed. TDA will ensure that policies are in place so that state appropriations continue to go directly to program development and not to pay lobbying fees.

6. The TDA Board of directors is not fully informed of financial transactions.

Response:
The Board of Directors of the TDA sets the organization's mission and its budget and directs management to carry out its financial transactions. Historically, reasonable steps have been taken to provide Board members with full documentation. However, it is clear that several Board members were not actually aware of the details of certain financial transactions.

B. BACKGROUND COMMENTS FOR CLARIFICATION

1. TDA loaned the [TDA] President $32,354 to participate in the First Flight Venture Fund without the formal approval of the [TDA] Board of Directors.

Response:

The TDA Board of Directors determined that it was appropriate to restructure TDA's equity investing activities in a more market-based manner, and delegated to a committee of the Board the responsibility for finalizing the restructuring which resulted in the creation by TDA of an independent entity, the First Flight Venture Fund, LLC ("FFVF"). The TDA Board of Directors also offered the TDA President an employment contract to serve as the President and CEO of TDA and the Manager of FFVF. As a part of the contract the President was offered the opportunity to participate in FFVF's investment gains as a "partner" in FFVF. Under Federal tax rules, in order to share in FFVF's investment gains as a "partner" in FFVF the President of TDA was required to make an investment of at

least 1% of the equity in FFVF. In capitalizing FFVF the President, supervised by the TDA Board-delegated committee, was allowed to make part of his 1% equity investment in the form of his promissory note payable to FFVF. This method of capitalizing FFVF is very common in the venture capital and private equity industry 1, and is the same method that has been used in most of the other venture capital funds in which TDA has invested over the years. PricewaterhouseCoopers has reviewed the structure and activities of the FFVF and found them consistent with other seed stage venture funds operating in the area.

This was not a cash distribution to the President from TDA or FFVF. While the details of the committee work were orally reported to the full Board during several different Board meetings, it is acknowledged that some TDA Board members not serving on the TDA Board-delegated committee were not able to answer questions about the details of this transaction. While the approval of the transaction by the Board-delegated committee is all that was legally required, it is acknowledged that there is a need for improved communications across the full TDA Board. TDA is taking steps to strengthen corporate governance and improve effective communications. During a meeting on December 7, 2001 the full TDA Board reviewed and unanimously ratified the establishment of FFVF, its Operating Agreement and the subject transactions thereof.

Background:
First Flight Venture Fund
First Flight Venture Fund (herein FFVF) is a limited liability company created to operate a venture capital fund. FFVF is a separate entity from TDA. It is not subject to the North Carolina Nonprofit Corporation Act, but instead is subject to the North Carolina Limited Liability Company Act. It is not subject to the TDA Bylaws, but instead is subject to its own Operating Agreement.

As described on the TDA website, the First Flight Venture Fund, LLC (FFVF) is the TDA's flagship seed-stage venture arm targeting the best high-growth technology businesses in North Carolina. FFVF seeks long-term investment opportunities, focusing on companies that provide a significant potential return on investment over a three to seven year horizon. FFVF investments enable the commercialization of innovative products and services developed by emerging growth businesses throughout the state.

The First Flight Venture Fund (FFVF) is not governed by TDA. FFVF is a separate legal entity. A separate management team governs FFVF. The Managing Director and contact person is Mr. Chris Kelly. The other three members of the investment team include David Emmett, Ted Morris, and the acting CFO of TDA. FFVF's investors or "members" elect this investment management team. The Advisory Board to the Fund comprises five (5) TDA Board members and two (2) non-TDA Board members.

Extensive information about FFVF is available on its website. This website is freely accessible through the TDA website. Confidential information is made available to TDA Board members through a password protected area of the website.

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1 See 2 J. Bartlett, Equity Finance: Venture Capital, Buyouts, Restructurings and Reorganizations §24.6 (2nd Ed. 1995); 1 M. Halloran, Venture Capital & Public Offering Negotiation, 1-40 (3rd Ed. 2001).

TDA did not "sell" any interest in FFVF to the President of TDA.

When FFVF was a newly formed entity, TDA invested in FFVF. The President was given the opportunity to invest, and did invest, in FFVF. As its investment in FFVF, TDA contributed to FFVF certain interests in portfolio company securities held by it and cash. As his personal investment in FFVF, the President of TDA contributed to FFVF $1,703 in cash and his promissory note made payable to FFVF in the amount of $32,354. This was not a "sale" by TDA to the President of TDA of an interest in FFVF, because TDA never owned the interest in FFVF issued to the President of TDA.

Also, the transaction was not a cash "loan" to the President by TDA or FFVF, as there were no funds flowing from TDA or FFVF to the President. Rather, the President was allowed to pay for his subscription in FFVF by delivering to FFVF his full recourse promissory note.

This transaction is consistent with the Board approved Operating Agreement of FFVF. The transaction is not subject to TDA bylaws or the North Carolina nonprofit corporation statutes.

Compensation Package Negotiated
History of Employment of David Emmett
In the 4th quarter of 1999, TDA needed a new president. TDA's Board undertook a national search for a new president. A number of applicants were interviewed. After a long search, TDA offered the position to Mr. David Emmett, who at that time was TDA's investment director in charge of venture capital. All Board members personally knew Mr. Emmett before assuming the position as president.

A fair and competitive compensation package was negotiated with Mr. Emmett. He accepted the position of President in December 1999. As often happens, he began work and the negotiations on his compensation package continued over the following six (6) months. He worked for TDA in good faith while the compensation package was negotiated.

While there may be individual members of the TDA Board of Directors who do not recall the specifics of the compensation package, it was negotiated fully and openly. This employment agreement was thoroughly negotiated by Mr. Emmett and a Board-delegated committee led by Mr. Walter Daniels, who was then the Chairman of the Board of Directors of TDA.

The committee that negotiated the employment agreement comprised Walter Daniels, Randy Overton, Orlan Johnson, John McConnell and Maceo Sloan. It is the policy of TDA that all committee meetings of all Board committees are open. Any Board member may freely attend any or all committee meetings.

Further, all compensation decisions were made by the committee of the Board. This committee had full authority to act on behalf of the Board. The TDA Board has 21 members, with 17 slots filled at this time. This is a large Board of volunteer directors. Often, the standing and special committees of the Board perform the detailed work of the Board. There are six standing committees, including the following: Nominating, Personnel, Venture Capital, Audit & Finance, Incubator, and Rural Lending Committees. All Board members are members of one or more standing committees.

Attached please find a copy of the minutes of the December 17, 1999 meeting of the TDA Board of Directors. The minutes clearly state that the Board discussed the need for an incentive compensation package for the employees of the Innovation Research Fund (now FFVF). The Board by written resolution resolved that an incentive based compensation structure for employees of the IRF (now FFVF) would make the compensation more competitive with industry and help attract and retain qualified employees.

The meetings of the committee following the Board resolution are not as well documented but the work of the committee is fully documented in the operating agreement and the attachments thereto. It is fully agreed and acknowledged that future Board minutes should contain more detail so that personnel decisions are fully documented in the records of the Board meetings.

Several meetings occurred in early 2000. Mr. Emmett, Mr. Robert Womble, an attorney representing TDA, and members of the committee, attended these meetings. Negotiations included agreements regarding Mr. Emmett's position on the management team of FFVF. This resulted in numerous revisions to the Operating Agreement of FFVF. This was an issue openly discussed by the full Board.

The Board discussed the issue of market -based performance compensation. These discussions were during TDA Board meetings in September 1999 and December 1999 and, further, at several Personnel Committee Meetings thereafter in 2000.

The Board determined that market-based compensation was a vital tool in recruiting and retaining personnel. The establishment of the First Flight Venture Fund, with a right on the part of the FFVF managers to participate in a portion of FFVF's portfolio company net investment gains, commonly known as a "carried interest," is and will continue to be a vital tool in recruiting and retaining TDA investment managers, including the TDA President.

After the President's employment agreement was executed, the said Board committee worked closely with TDA's legal counsel. The group crafted a very conservative and public policy minded Operating Agreement for FFVF. The concept is an investment entity separate from TDA, called FFVF. The FFVF Operating Agreement includes a "carried interest" component as agreed. This "carried interest" is also referenced in paragraph 5.d. of the TDA President's Board-approved employment contract.

The "carried interest" component of the FFVF Operating Agreement has several purposes. The first purpose is to preserve the state mandate of TDA, to wit: to create jobs and create wealth in NC. The second purpose is to reward investment managers for performance. The third purpose is to provide a retention tool through vesting.

In view of the unique position of TDA as a non-profit entity, strict criteria were adopted. This conservative approach resulted in a FFVF Operating Agreement that provides a smaller profit sharing percentage and a longer vesting period for investment managers than are normally the cases with market-based private equity and venture capital funds.

The draft audit report states that the FFVF "carried interest" held by the President of TDA is in the "net profits" of FFVF. This is not correct. The "carried interest" is in the net gains from portfolio company investments made by FFVF.

The draft audit report also states that the FFVF "carried interest" held by the President is fully vested. This is not correct. The "carried interest" vests over a seven-year period.

The FFVF Operating Agreement mirrors market practices. The Operating Agreement requires an investment in 1% of the FFVF capital by the TDA President as a managing member of FFVF. There are two reasons for this investment requirement. First, the federal tax laws require this in order for the managers to be treated as members rather than as employees for tax purposes. Second, this requirement is necessary in order to protect TDA. It is reasonable and proper to have distance between TDA and FFVF. Third, this requirement is necessary to avoid any perception of private inurement or private benefit to individuals because of their relationship to TDA. The investors of FFVF paid money into FFVF, and were allocated their proportionate share of the income of FFVF. The monies paid were a return on invested capital, and were not compensation.

It is consistent with market practice to allow a substantial portion of the required 1% investment from a venture capital or private equity fund manager to be in the form of a full-recourse promissory note. No cash loan from TDA was made to the TDA President to invest in this fund. The promissory note from the FFVF has been paid in full and retired in full with all interest paid.

The draft audit report states that the Promissory Note issued by the President of TDA to FFVF was to be paid by September 30, 2000. This is a misstatement. Rather, the said Promissory Note provides that it was to be paid on December 31, 2009, with mandatory prepayments from distributions to the President of TDA by FFVF.

The President complied with all prepayment requirements of the promissory note. The first distribution to the President of TDA from FFVF was not made until April 3, 2001. On April 6, 2001, the President of TDA made the required prepayment in full of the promissory note in the amount of $34,457. This payment was for all principal and interest accrued. The note returned a market rate of interest to the fund and was paid in full over eight years prior to the December 31, 2009 due date.

The President's personal check of $1,703 was deposited late due to delays in establishing the proper separate brokerage accounts for the FFVF and in part due to slippage during the full time controller's maternity leave. The President will voluntarily pay interest on the check for the time it went undeposited. The Board reprimanded the President for this oversight.

Note: Pursuant to Session Law 2001-424, Section 20.8, the NCTDA has entered into a Memorandum of Understanding with the Attorney General's office to negotiate an agreement that specifies the manner in which any profits will be shared with the state.

2. **TDA executive compensation appears excessive compared to other organizations funded primarily through state appropriations.**

Response:
TDA provides competitive salaries that are performance-based and commensurate with the responsibilities of each position. The comparison to other organizations funded primarily through state appropriations is an inappropriate comparison given the unique nature of TDA.
For the second year in a row, TDA's actual salaries expense as reflected in the audited financial statements for the respective fiscal years ended September 30, were below the Board-approved budget amount. The report states that the President's salary is $220,346. The actual annual base salary for the President of the TDA is $127,000. The President has instructed the Board that he will not accept the $40,000 bonus payable per his contract.

During the period of time analyzed, TDA was not funded primarily through state appropriations. Returns from investments of TDA were the greater portion of the income of TDA during this period. Although state appropriations have enabled TDA to perform its mandate from the NC General Assembly, it has succeeded in creating capital to help sustain TDA. It is the stated goal of TDA to become self-sufficient. TDA is in the process of working to create systems of financial support to enable it to become self-sufficient so that it would not require state appropriations on an ongoing basis.

Further, TDA is in a unique position as a non-profit corporation that receives state appropriations and receives income from investments. Investing money creating jobs and making money is at the heart of TDA's business and mandate. Most organizations that receive state appropriations are not in the business of investing money and creating wealth.

Background:

President of TDA:
The base salary for the President and CEO of the TDA is $127,000. The range of salaries for CEOs of non-profit organizations of similar size and budget is $191,786 to $204,102 [2]

[2] Bob Brinkley, Comp Design, Management Compensation Survey of 318 Not for Profit Companies. December 2001

The TDA Personnel Committee reviewed the duties and responsibilities of the TDA President, reviewed Mr. Emmett's employment history and accomplishments, and set his starting base salary in January 2000 at $100,000 per year.

In the year 2000, TDA reached certain significant financial milestones. The Board awarded bonuses, and the President's salary was adjusted upward to $127,000 per year. The table below shows the actual annual net compensation of the President of TDA, as reflected in the audited financial statements for the respective fiscal years ended September 30.

TDA President's Income Analysis

Year 2000	**Income**	**Notes**
Base	$110,000	Base rate was $100K for the first six months of the year and $120K for the second six months.
Bonus	$56,000	Part of which was in recognition of achieved milestones and part of which was in recognition of past performance at TDA.
2000 Total	**$166,000**	
Year 2001	**Income**	**Notes**
Base	$127,000	Board-approved salary, adjusted upward from 2000.
Bonus	$ 10,000	Paid in January 2001 for 2000 performance.
FFVF Net	$ 7,187	Total FFVF distributions of $43,347 less FFVF investments of $36,160.
2001 Total (projected)	**$144,187**	The Personnel Committee conducts an annual performance review of the President each January for the past year's performance. For the year 2001 the President has waived the $40,000 bonus referenced in his contract.

The President received $43,347 in distributions from FFVF in 2001. It is important to note that $19,395 of this amount is attributable to the 1% interest in FFVF in which the President invested with his own money. That is not a compensatory distribution. That one time payment is a return on the capital invested in FFVF by the President. Only $23,952 of the distribution is attributable to the compensatory "carried interest" held by the TDA President.

The draft audit report assumes that the TDA President will receive similar "carried interest" distributions from FFVF in future years. This assumption inaccurately portrays the reality of the future compensation for the President.

These distributions are the result of successful "exits" of portfolio company investments by FFVF, which occur at irregular intervals. In this particular case, the distribution was attributable to the successful "exit" by FFVF of its investment in SciQuest, Inc. The SciQuest investment had been held for a number of years prior to the "exit." This was the largest liquidity event in the history of TDA. It is unclear whether there are other companies within the FFVF investment portfolio that will lead to similar investment gains.

The $220,346 presented in the draft report, as "2001 Compensation" is inaccurate because it is captured over a period of more than twelve months that distorts the actual annual compensation package of the President.

The result is an inaccurate perspective of the compensation. This sum includes a $10,000 bonus from the 2000 calendar year that was paid in January 2001. That money was earned in 2000. It also includes $43,347 in distributions from FFVF without netting the costs of $36,610 of the investment by the TDA President in FFVF. Finally, it includes a $40,000 bonus that the President has informed the Board he will waive. The compensation earned in 2001 and paid in 2001 to the President through November 30, 2001 is $116,417.

<u>CFO of TDA</u>:
The draft report inadvertently overstates the CFO's compensation. The annual salary of the TDA's CFO/Project Manager position for 2001 was $108,000. The total of $160,000 as presented in the table in the draft audit report is inaccurate. The CFO was not and will not be paid $160,000 per year.

The stated $160,000 sum includes a one-time payment of $10,000 that was paid to the CFO under a consulting agreement that was in effect prior to his becoming an employee of TDA. This was money paid to him for performance in a prior year's contract.

Further, the stated $160,000 figure includes a $42,000 bonus figure that was not paid and will not be paid. The CFO function has been restructured, and the prior CFO is no longer employed by TDA.

The fulltime CFO position formerly filled by Mr. Ernest Leonard was designed to include responsibility for certain project management duties in addition to the CFO function. Mr. Leonard's salary was set in recognition of these duties, commensurate with those paid to other financial management professionals during a period of very low unemployment in RTP.

Last year TDA management implemented a plan to outsource many of the historical accounting functions of TDA. Many of Mr. Leonard's financial management duties have been outsourced. Due to the slowdown in the economy there are fewer projects to be managed by the CFO than were previously anticipated. The combination of these circumstances has reduced the TDA's need for Mr. Leonard's services, and his employment with TDA has ended. Upon the termination of Mr. Leonard's employment with TDA, the projects formerly managed by Mr. Leonard are being reassigned to other current members of TDA staff.

Because Mr. Leonard's employment with TDA has ended, he will not have vested in the 2% "carried interest" of FVFF.

<u>Total TDA Salaries and Employee Benefits</u>:
In the 18 months ending September 30, 2000, TDA received $4,000,000 in appropriated funds from the North Carolina General Assembly. Further, TDA generated an additional $4,961,649 from operations for total revenue of $8,961,649. TDA salaries and employee benefits for the same period were $1,943,764.

The success of TDA's generation of capital enabled TDA to completely fund salaries and employee benefits with revenue dollars. All salaries and employee benefits have been paid from TDA's successful generation of capital.

TDA has applied all state appropriated funds entirely to program delivery and expansion.
All state appropriations have been spent on the programs designed to create jobs in North Carolina.

TDA has been enormously successful in doing what the State of NC has mandated TDA to do: create jobs and create wealth in NC. TDA has been recognized as being outstandingly successful in this mandate. The NC Electronics and Information Technology Association named TDA as the "Top Not for Profit Company of the Year" in recognition of outstanding performance in 1999.

TDA cannot be viewed as a typical state agency. It was spun out from the NC Dept. of Commerce precisely because it did not function well as a state agency. It is a public benefit entity working in a for-profit environment. This presents challenges, and TDA has met these challenges and succeeded beyond all expectations. The reason that TDA has succeeded is that it has competed in the market place for competent people. The management staff is fully capable of performing and delivering in the market place.

The opinion of the Auditor that the compensation is "excessive" is based on comparisons with state government agencies and non-profits that may not work in the capital formation, high technology transfer and venture capital arenas.

3. **TDA contracted with CFO's brother and CFO's former business partner.**

Response:
It is true that TDA contracted with the CFO's brother and with the CFO's former business partner. The CFO is no longer employed by TDA. While no conflict of interest existed, all contractual relationships with his brother and with his former business partner have been terminated.

Mr. Michael Leonard, Brother
TDA accepted a contract bid from the CFO's brother to perform landscaping services, including lawn mowing. Contracts were bid competitively and were for market rates. TDA received fair value from work performed by Mr. Mike Leonard. The CFO did not directly contract with his brother, and received no benefit from the arrangement.

The CFO filed a written statement with TDA confirming that he did not have a material financial interest that would constitute a conflict with his brother during the contract period. The situation does not have a good appearance for TDA, and steps have been taken to insure strict enforcement of TDA's conflict of interest policy. The CFO has left, and the landscape contract has been terminated.

Background:
Brother
TDA's RTP facilities include a 9,150-foot building located on eight (8) acres of property, with an assessed value of $1,700,606. These facilities require regular maintenance.

Prior to September 2000, TDA employed a part-time maintenance employee whose duties included cutting the grass. The part-time employee performed no other landscaping functions. After the part-time employee resigned, TDA in accordance with both the State Personnel Manual and TDA internal policies and procedures developed an RFP for grass mowing and several other landscaping requirements. The incubator manager accepted the lowest bid.

The NCTDA saved money by outsourcing the landscaping. The hourly comparison in the draft audit report does not account for, 1) the significantly shorter project time when using the landscaping crew, 2) landscaping materials included in the landscaping contract, and 3) specialty landscaping that was not provided by the part-time employee.

Mr. Ty Cox, Former Business Partner
Mr. Cox's firm performed temporary professional accounting services during the maternity leave of a staff accountant. This was at the market rate of pay. The rate of pay for these accounting services was $70 per hour.

The draft audit report inaccurately compares the temporary Certified Public Accountant's rate of $70 per hour to the $27 per hour rate of a temporary bookkeeper. TDA paid a market rate to the temporary Certified Public Accountant supplied by Mr. Cox's firm.

The section of the TDA Bylaws quoted in the draft audit report references the conflict of interest provisions of the NC Nonprofit Corporation Act. This Act normally applies only to members of the Board of Directors of a nonprofit corporation. The Bylaws of TDA extends the application of those provisions to the employees of TDA.

The Bylaws provide that it as a conflict of interest for a Director or employee of TDA to cause TDA to engage in a transaction in which the Director or employee has a **direct financial interest** or with an entity in which the Director or employee is a **general partner or has a material financial interest.**

The former CFO, a TDA employee, filed a written statement with the TDA confirming that he had no direct financial interest in the accounting firm that received the payment. Further, the former CFO was not a general partner with Mr. Cox at the time of the said financial transaction. Further, the former CFO had no material financial interest in the payments to Mr. Cox. This contract was signed by the President of the TDA not the CFO.

All the facts show is that the former CFO, a TDA employee, and the person contracted by TDA were for a brief period of time partners in an unrelated business. Based upon this, the conflict of interest provisions of the TDA Bylaws and the North Carolina Nonprofit Corporation Act are not applicable to the described activities.

Summary for both perceived conflicts
Neither of these transactions was with an entity in which the TDA employee was a general partner or had a material financial interest.

Although there were no actual direct or indirect conflicts, the perception of conflicts has been removed. TDA's relationships with the referenced CFO, his brother, and his former business partner have all been terminated.

4. **TDA does not have written policies controlling travel and entertainment expenses.**

Response:
TDA has a written policy controlling travel and entertainment expenses, and has had since the early 1990's. Further, the said policy was reviewed and updated by the Board in 2001. Regrettably the policy does not cover all the issues raised by the State Auditor and the Board of Directors has directed the Audit and Finance Committee to review and tighten these policies.

TDA has a written policy controlling travel and entertainment expenses. It is fully acknowledged that management should and has already taken steps to strengthen the administration and enforcement of these written policies with regard to travel and entertainment.

NCTDA is appreciative of having the benefit of the auditor's findings in this matter. The Board has directed the Audit and Finance Committee to develop tighter policies on its travel and entertainment. We offer the following for clarification:

Background:

TDA's written policy controlling travel and entertainment expenses is contained in section 4-2 of the TDA Employee Handbook. Each TDA employee has received and signed for a copy of the handbook. Copies of the handbook have also been made available to the members of the TDA Board of Directors.

TDA acknowledges that the written policy is broad. The language in the written policy can certainly be made more restrictive. Corrective action is underway to include policy updates, revisions, and personnel counseling.

The written policy states that reasonable expenses, including travel expenses that are incurred as a direct result of an employee performing duties of his or her job, are eligible for reimbursement by TDA.

According to TDA's written policy, in order to obtain an expense reimbursement a TDA employee must prepare, sign, and submit to his/her supervisor for approval an Expense Reimbursement Request (Exhibit B in the handbook) along with receipts.

The Employee Expense Reimbursement form is provided to all employees. This written form contains reasonable guidelines, which are not absolute policy, for reimbursable food and lodging expenses and the reimbursement rate for mileage.

<u>Specific Expense Items</u>:

- In 2000-2001 TDA scheduled Board meetings across the state so that the Directors could see first-hand the results of TDA's investment programs. In addition, these quarterly meetings served as extension and outreach opportunities and were often hosted and partially funded by local economic development organizations. As important as these functions are, it is also important to cut costs in times of financial downturn. TDA management presented to the Board and the Board approved in 2001 a budget for the current fiscal year (2001-2002) that significantly reduces the budget items for Board travel and entertainment.

- For each of the past five (5) years TDA has had a prominent presence at the National Association for Seed and Venture Funds (www.nasfv.org) annual conference. This is the preeminent conference in the country for state-funded investment programs. These annual conferences provide a unique opportunity for the free exchange of ideas. This forum is where best practices in the field are shared. The President and Board Members have been featured speakers at these conferences. In November 2000, the President, Mr. McClees, and three Board members attended the annual conference held in Hawaii.

- There was a Board meeting held in June 1999. The TDA reserved a block of rooms at the Radisson Hotel and some were used by directors. However, a total of 9 rooms were not used and not cancelled. These rooms were billed to the TDA. This was an inadvertent error by staff prior to Mr. Emmett's tenure as president.

- In October 2000, TDA staff presented to the TDA President a gift for Bosses Day. Erroneously and without the knowledge of Mr. Emmett, this gift from staff was paid for by TDA. The President later learned that the gift was purchased for $211.00 using TDA funds. Upon learning of this error, the President immediately reimbursed TDA for this inappropriate expenditure.

- The staff member who charged a meal at Sullivan's for $65.21 was reprimanded in writing. This was an inappropriate expenditure.

- The $429.59 spent at the 42nd Street Oyster Bar was for an event hosted by TDA for fifteen (15) members of the NC General Assembly.

- The October 11, 2000 “staff event” for $1,328.51 as referenced in the report was paid to Jillian’s Restaurant in Raleigh. The payment was for an August 2000 staff function honoring the service of TDA’s summer interns. This was designed to increase office morale and to raise the profile of TDA as an employer in the area. Family members of staff and the summer interns attended the dinner.

- The staff and interns worked through lunch on April 17, 2000 and July 24, 2000. The staff did not take their normal time off for lunch. TDA provided a delivered lunch for the staff.

- Startups that participate in TDA’s incubation programs have a first year survival rate of 87% vs. the national average of 50%. As a component of TDA’s incubation and education services to its tenants, TDA hosts a quarterly luncheon. Topics include small business counseling, fund raising strategies, and business development assistance.

  The tenant luncheon referenced as having been on March 5, 2001 was actually held on January 19, 2001 at the TDA building. TDA purchased food from Pizza Hut for the tenants.

TDA welcomes the valuable input from the State Auditor regarding these important financial controls. The Board has directed the Audit and Finance Committee to review the TDA’s travel and entertainment policies and implement improvements. TDA welcomes any further recommendations or input that the Auditor could make available.

5. **The TDA Board of directors is not fully informed of financial transactions.**

Response:
The Board of Directors of the TDA sets the organization’s mission and its budget and directs management to carry out its financial transactions. Historically, reasonable steps have been taken to provide Board members with full documentation. However, it is clear that several Board members were not able to answer questions regarding the details of certain financial transactions.

It is a challenge to keep a large, volunteer Board fully informed. Further, much of the detailed work is done in committees, with more general reports to the full Board.
In response to this challenge, TDA management sends a company update to the full Board at least monthly. In addition, management has recently designed a password protected intranet site that serves as an information repository for round the clock access by the Board.

As mentioned in the response to item #1, members of working committees have more detailed knowledge of the specific transactions associated with their committee business. However, TDA acknowledges the need for more thorough communication and documentation of the committees work to the full Board.

Written reports

Detailed financial information is regularly reported to appropriate committees of the TDA Board of Directors and at quarterly meetings of the full Board of Directors. Much of the work of the Board is conducted in the committees. Therefore, a Board member not on a particular committee would not receive as much detailed information as the committee members. He or she would, however, receive reports at the full Board meetings. Further, all Board members are free to request information from the various committees.

The six standing committees regularly receive the following documentation:

Nominating Committee	Meets as needed	Receives resumes of potential Board members
Audit & Finance Committee	Meets quarterly or additionally as needed	Receives income statement, balance sheet and cash flow statements
Personnel Committee	Meets as needed	Receives performance reviews and compensation data
Incubator Committee	Meets quarterly or additionally as needed	Receives incubator feasibility study reports, reports on TDA's incubator portfolio, and TDA management's recommendations for new incubators
Venture Capital Committee	Meets quarterly or additionally as needed	Receives venture capital portfolio updates, current deal status reports, and future funding recommendations.
Rural Lending Committee	Meets quarterly or additionally as needed	Receives portfolio updates, current deal status reports, and future funding recommendations.

Background:

Management proactively reports detailed financial information to the TDA Board of Directors. It is a challenge to keep a large volunteer Board informed.

The Audit & Finance Committee of the TDA Board of Directors does not have responsibility for reviewing TDA consulting contracts or for TDA officer compensation. These items are the responsibilities of the Personnel Committee. Further, the Audit & Finance Committee reviews the budget quarterly.

6. **TDA expended $549,726 for lobbying and consulting expenses during a two-year period.**

Response:
The lobbying and consulting expenditures include a broad array of work by TDA, including work on long range funding sources to enable the organization to become less dependent on state appropriations. Services from McClees Consulting include both lobbying and consulting. State lobbying fees and expenses for the period analyzed are about 2.4% of the state appropriation.

It is true that TDA has expended monies for lobbying and for consulting work to benefit NC. Lobbying and consulting expenditures have been necessary and successful since the first year of TDA's existence. TDA has a streamlined staff and uses consultants to keep its fixed overhead low.

Since its inception, TDA has not been in the State's recurring budget. No governor has ever placed TDA in the Governor's recommended budget. Therefore, it has been necessary every year for TDA to lobby the NC General Assembly for an annual appropriation. This necessarily involves engaging a lobbying firm. The reality of the budget process in NC makes it impossible to present one's case to the legislature without a designated representative who can spend the time and effort necessary to communicate effectively in the legislative process.

The firm has succeeded in having TDA included in the NC budget each year since its inception. This would not have been possible but for the efforts of McClees Consulting. Further, TDA would not have survived or now be in existence but for the state appropriations.

The fees paid TDA's lobbying firm are reasonable given the nature of the services rendered by TDA's lobbying firm. Further, there are no guaranteed expenses. All expenses are submitted to TDA and paid only upon a finding of the reasonableness of the expense items.

There are separate contracts for lobbying and consulting services, each of which is specified for the type of work and the scope of said work.

Background:

McClees Consulting provides lobbying and consulting services to the TDA. In addition to assisting TDA in raising state funds, McClees Consulting advises TDA in economic development, capital formation, and federal government relations. McClees Consulting, Inc. has been involved with TDA from its inception, and has a depth of historical knowledge, expertise, and ability to aid TDA in the furtherance of TDA's goals.

STATE LOBBYING ACTIVITIES
For the two-year period ended September 30, 2001; TDA paid McClees Consulting a total of, $187,347 for state lobbying fees and expenses. The total state funds raised by TDA during

that period were $7,000,000. Lobbying costs were only 2.4% of the total state funds raised. This is well within the state of North Carolina's published guidelines of 4%.

Since 1991, NCTDA has paid McClees Consulting approximately $400,000 for state lobbying and expenses. During that period the NCTDA has received about $19,000,000 of state funding. State lobbying fees and expenses paid to McClees Consulting from the TDA are about 2.1% of state funds raised since the company was privatized.

Further, the NC General Assembly just completed the longest legislative session in NC's history. Further, the budget approved earlier in the session is widely known to be out of balance due to declining revenues. It is generally acknowledged that the NC General Assembly will be forced to reconvene early in 2002 to address the budgetary shortfall. This means that TDA's state appropriation, as are all other state appropriations, is subject to modification. The continuing presence of TDA's lobbyist is absolutely necessary to help protect TDA's state appropriation in the current budgetary crisis. TDA's state appropriation is absolutely necessary to continue the work of TDA as TDA fulfills its state mandated economic development mission.

TDA does acknowledge that lobbying expenses for 2001 are higher due to the length of the session, work to secure an appropriation in the State budget for TDA in a difficult budget year, and the work on TDA's "Miracle Grow" project. "Miracle Grow" is the proposal to enable a technology development investment fund secured by contingent tax credits. This would encourage seed stage capital investment in North Carolina.

Further, due to the budgetary problems of the State of NC, TDA's appropriation this year was lower than hoped. Many state appropriations for agencies and other recipients were much lower than expected. The State continues to have budgetary problems. It has taken a great deal of work this year and will continue to require more work to maintain a state appropriation for TDA.

CONSULTING ACTIVITIES
The consulting assistance provided by McClees Consulting, Inc. is vitally important to TDA. These activities are related to the development of TDA's expanding role in economic development in North Carolina. These are not lobbying activities. These are activities related to the development of specific TDA programs and support for several federal applications that delivered over $3M of funds for the TDA's state mission.

Agri-Products
McClees Consulting, Inc. played a key role in developing the North Carolina AgriProducts Alliance Incubator ("**NCAAI**"), a public private university partnership among TDA, NC State University, the NC Dept. of Agriculture, Progress Energy, and many other state and federal organizations. This program seeks to catalyze the intersection of North Carolina's oldest industry – agriculture, with one of North Carolina's newest industries – biotechnology.

The NCAAI will support TDA's mission of creating jobs and wealth by providing business, marketing, and technical assistance to entrepreneurs in value-added food and agricultural products.

GoldenLeaf Foundation
Due in part to the work of McClees Consulting, Inc., TDA has been selected by the GoldenLeaf Foundation for funding support for job creation in the agri-products area of North Carolina's economy.

"Miracle Grow" is a TDA nickname for plan for a Contingent Tax Credit
In working on the contingent tax credit plan, McClees Consulting demonstrated its ability to assist in the development of an innovative plan and strategy for TDA. McClees Consulting assisted the President in crafting the concept of a contingent tax credit to induce participation in an investment fund managed by TDA. McClees Consulting worked with Mr. Emmett to formulate a structure in which TDA can accomplish the mandate of the NC General Assembly and do so without the necessity of ongoing state appropriations.

When successful, the profits from this investment fund will sustain TDA, and will decrease the need for lobbying efforts by TDA. The investment fund strengthened by the contingent tax credit will allow TDA to borrow and secure funds in such a manner so as to build business incubators; do seed stage capital, and other related activities.

Initially, McClees Consulting worked with Mr. Emmett to develop the document outline of the concept of the contingent tax credit. Then, McClees Consulting worked with Mr. Emmett to draw together a team of experts to build the concept into a fully developed proposal.

7. Conclusion.

TDA's success in recent years has come with the recognition that TDA must work and think like a for profit business. TDA's Board and management team have worked hard to propel TDA into the successes it has seen in recent years.

History of TDA
A committee of the North Carolina Entrepreneurial Development Board conducted the last major review of TDA in 1993, 1994 and 1995, as a part of the Entrepreneurial Development Board's review of state-supported entrepreneurial development initiatives including TDA, MCNC, and the North Carolina Biotechnology Center.

That early 1990's review found that TDA was ineffective, and was more critical of TDA than any of the other organizations reviewed. TDA's portfolio company investment program was severely criticized, largely because most of the portfolio company investments had become worthless. The Entrepreneurial Development Board found that the TDA management team had come out of state government and had a governmental "economic development" viewpoint on matters. TDA desperately needed a management team coming out of business with a business viewpoint. TDA was encouraged by the Entrepreneurial Development Board to invest in portfolio companies with more of an emphasis on a financial return on investment.

TDA reoriented to business approach
In the mid-1990's, TDA recruited a new business-oriented management team. This was done with the encouragement of the Entrepreneurial Development Board. TDA gave the new team a mandate to run TDA more like a business. As a result, the investment program was revamped to operate more like that of a private venture capital fund. In order to attract qualified managers for the investment program, it is necessary to compensate them in a manner similar to that of private venture capital funds.

TDA has learned the hard way that it must work and think like a for profit organization. It is therefore unfair to compare TDA salaries with that of state government salaries. The Auditor's draft report seems to base its conclusions on a comparison of TDA compensation with that of state government. The compensation of the TDA management team should not be compared to the compensation of state governmental personnel. The fair and accurate comparison must be with the compensation of persons involved in the venture capital industry. Such a comparison will reveal that the TDA personnel are under-compensated when compared to their counterparts in the venture capital industry.

The draft audit report seems to suggest that TDA should retreat from the progress made as a result of the Entrepreneurial Development Board's recommendations, and return to its former "non-profit mentality".

It has been the experience in many states that any state supported investment program that operates with an economic development focus rather than a profit-oriented focus is doomed to failure. If the investments are made with profits in mind, then those companies that are profitable will as a necessary byproduct of their profitability generate jobs. However, if investments are made with only job development in mind, profits may not necessarily follow and eventually there will be no funds left with which to make investments.

The efforts of the current TDA management team have been very successful. For the 18 months ending September 30, 2000, TDA and its affiliates invested in seed stage technology companies and incubator projects in North Carolina that attracted follow-on funding in excess of $120,000,000. Additionally, TDA invested in venture funds located in North Carolina, catalyzing an additional $110,000,000 in early stage capital under management.

In seventeen years of operations, TDA has developed an efficient formula for creating jobs and wealth for North Carolina. In 1983, NC House Bill 1122 established TDA and gave it the authority "to establish incubators to transfer technologies into commercial applications by private industry." Since 1983, TDA has expanded its offering to provide and connect entrepreneurs with business incubation, venture capital, technology transfer, rural initiatives and entrepreneurial expertise to commercialize promising business opportunities.

Additionally, TDA embraces a statewide approach through which we accelerate these growth tools out of localized technology hubs and urban centers for the benefit of rural North Carolina. TDA, therefore, is an important component of North Carolina's science and technology investment, as well as integral to efforts by State leaders to ensure that returns on public investment in research, development and deployment are maximized and equitably beneficial to all the citizens of the State.3

Summary of TDA successes

Over the last ten years, the NC Legislature has supported TDA's operations and expansion. TDA has produced one of the highest returns on investment of any state-backed economic development corporation. These returns have accrued as:

- 12,000 good paying new jobs for North Carolinians -- 7,000 jobs created directly and 5,000 jobs created secondarily
- 23 TDA managed and affiliated business incubators offering over 346,700 square feet to entrepreneurs across North Carolina
- 765 companies supported by TDA managed incubators
- TDA investment in statewide incubator network of $6,393,150 leveraged 2:1 with follow-on of $12,398,850 and property appreciation of $8,078,000
- $4,084,899 invested through the First Flight Venture Fund
- $1,447,514 seeding 9 venture capital funds leveraged 90:1 to amass $131,552,486 in risk capital in North Carolina, much of the commitments coming from outside the state.
- Academy Centennial Fund providing $10,000,000 pre-seed and seed capital to commercialize promising NC State Technologies
    - $1,250,000 in new sponsored research at NC State
    - Over 40 innovations licensed from NC State
    - More than 225 new high paying jobs created
    - Over $42,000,000 in combined corporate operating budgets in North Carolina
    - Portfolio companies have leveraged Academy Centennials investments 17:1 raising more that $100,000,000 from follow-on investment. Much from out of state.
- More than $2.25 million in loans for businesses in rural North Carolina – current projected annual corporate revenues of $3,807,850 – 88 new jobs created by these loans.
- $150,000 for new Agri-products Incubator Initiative providing comprehensive business development programs for training rural food entrepreneurs, thus expanding North Carolina's agricultural markets and connecting biotechnology with agribusiness.
- Working directly with the UNC System Office of the President to increase government-sponsored research at NC universities and help increase the economic impact of new university technologies.

These efforts, and the corresponding successful results, have been recognized. One such recognition was received from the North Carolina Electronics and Information Technology Association. This Association recognized TDA to be the most effective government-related non-profit organization.

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[3] North Carolina Board of Science and Technology. 2000. *Forces for Change – An Economy in Transition*. A report prepared as part of the Vision 2030 Project.

LOOK AHEAD

TDA is eager to improve the standards of excellence in every area of its work. As TDA moves forward to accomplish the mandate given to TDA by the NC General Assembly, we hope that we receive recognition for our accomplishments on behalf of the economy and the people of North Carolina. We accept positive suggestions for improvements.

More importantly, we agree with the editorial in the News and Observer on December 11th calling for more of the type of creative policy thinking that created the Research Triangle Park and the TDA. Governor Easley has asked his new economic development advisory group to recommend preparations for an economy that relies less on low-skill workers. "North Carolina must focus more attention on creating and attracting high-skill jobs that pay better wages than most factory work." We humbly suggest that TDA's brand of high technology economic development be a more prominent part of North Carolina's comprehensive plan.

TDA is very grateful to the State Auditors Office for pointing out certain areas that require improvement. The Board and management have developed a corrective action plan and launched its implementation. We have attempted to answer all points that were raised by the review, however, in any instance if there is any area that is not fully answered please give us the opportunity to speak more directly or in more detail.

PRICEWATERHOUSECOOPERS

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Mr John McConnell
Chairman of the Board
NC Technological Development Authority, Inc. (TDA)
2 Davis Drive
RTP, NC. 27709

Dear Mr. McConnell,

At your request, PricewaterhouseCoopers LLP has monitored the progress and preliminary results of the audit of the TDA's operations currently being performed by the North Carolina State Auditor's office. As a part of that monitoring process, we have:

- Conferred with management as the state audit was being performed,
- Read the draft report from the state auditors presented to the TDA in mid-November,
- Provided our observations concerning the matters included in the draft report,
- Read the draft response prepared by the TDA,
- Reviewed our past external audit results and the results to date of our audit of the September 30, 2001 external audit,
- Met with TDA executives and certain outside consultants, and
- Reviewed certain specific documentation available at the TDA

We would like to make the following observations as a result of these actions:

- The state auditors' preliminary report does not imply that any monies were wrongfully spent or that any actions taken by the TDA or its executives involved the violation of any civil or criminal law.
- The report does not explicitly state that any parties mentioned in the report should repay any monies.
- The report does not affirm that any expenditure was improperly classified or misreported to the Board, the external auditors or any oversight group.

PRICEWATERHOUSECOOPERS

- Our audit of the consolidated financial statements of the TDA for the year ended September 30, 2000 and 1999 resulted in the issuance of unqualified opinions. Our report on the 2001 financial statements has not been issued at this date, but the preliminary results of our fieldwork did not bring to light any significant differences, and we anticipate the issuance of an unqualified opinion when appropriate.

- In conjunction with our audits in 2000 and 1999, we issued letters to management affirming that, for the portions of the internal control that we considered as a part of our audits, we did not note any material weaknesses in internal control, as defined in generally accepted auditing standards. As this point in time, we anticipate issuing a similar letter related to the 2001 audit.

- Our audit scope necessarily encompassed the First Flight Venture Fund because of the inclusion of its financial results in the consolidated financial statements of the TDA. Our procedures have necessarily involved a review of the formation of FFVF and its ongoing management and results. Our observations over the period since its formation are that FFVF has been formed and operated in a manner consistent with other venture funds involved in seed and early stage companies.

As regards the response prepared by the TDA management, we have provided some input to management regarding the matters noted. Further, we have reviewed the specific actions taken by management in the following areas:

- Reviewed the table of the actual net compensation paid to the President and compared that information to our audit workpapers,

- Examined documentation of the repayment of the note payable to the FFVF from the President, and

- Examined documentation of the repayment by the President of the value of the staff gift.

Please feel free to contact me if you have additional questions or concerns or would like us to pursue any matters further.

Sincerely,

Peter J. Coode

Peter J. Coode, Partner

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In accordance with G.S. §147-64.5 and G.S. §147-64.6(c)(14), copies of this report have been distributed to the public officials listed below. Additional copies are provided to other legislators, state officials, the press, and the general public upon request.

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December 13, 2001

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