The Honorable Donald T. DiFrancesco  
Acting Governor of New Jersey

The Honorable Donald T. DiFrancesco  
President of the Senate

The Honorable Jack Collins  
Speaker of the General Assembly

Mr. Albert Porroni  
Executive Director  
Office of Legislative Services

Enclosed is our report on the audit of the New Jersey Commission on Science and Technology for the period July 1, 1999 to August 28, 2001.

If you would like a personal briefing, please call me at (609) 292-3700.

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New Jersey Commission on Science and Technology

**Scope**

We have completed an audit of the New Jersey Commission on Science and Technology for the period July 1, 1999 through August 28, 2001. Our audit included financial activities accounted for in the state’s General Fund.

Established in 1985, the commission is responsible for the development and oversight of policies and programs in science and technology that can advance economic development and employment in the State of New Jersey.

Fiscal year 2000 and 2001 expenditures of the commission were $14.3 million and $23.5 million, respectively, which included grant expenditures of the commission of $13.7 million and $22.7 million, respectively.

**Objectives**

The objectives of our audit were to determine whether financial transactions were related to the commission’s programs, were reasonable, and were recorded properly in the accounting system.

This audit was conducted pursuant to the State Auditor’s responsibilities as set forth in Article VII, Section 1, Paragraph 6 of the State Constitution and Title 52 of the New Jersey Statutes.

**Methodology**

Our audit was conducted in accordance with Government Auditing Standards, issued by the Comptroller General of the United States. In preparation for our testing, we studied legislation, administrative code, circular letters promulgated by the State Comptroller, and policies of the commission. Provisions that we considered significant were documented and compliance with those requirements was verified by interview, observation, and through our samples of financial transactions. We also read the budget message.
reviewed financial trends, read the minutes of the commission meetings, and interviewed commission personnel to obtain an understanding of the grant programs and the internal controls.

A nonstatistical sampling approach was used. Our samples of financial transactions were designed to provide conclusions about the validity of transactions as well as internal control and compliance attributes. Sample populations were sorted and transactions were judgmentally selected for testing.

Conclusions

We found that the financial transactions included in our testing were related to the commission’s programs, were reasonable, and were properly recorded in the accounting system. In making this determination, we noted certain internal control weaknesses merit management’s attention.
**Early Stage Enterprises**

In 1995, in response to a lack of venture capital, the commission initiated a venture capital fund to target New Jersey companies. The Early Stage Enterprises Limited Partnership (ESE) was created to leverage $4.3 million of state funds into approximately $30 million through joint investments with private industry and the federal Small Business Administration.

The request for proposals for a general partner to manage the fund indicated that companies eligible for investment must be located in New Jersey. Early Stage Enterprises’ proposal stated that it was committed to making all of its investments in New Jersey companies. The commission entered into a limited partnership agreement with Early Stage Enterprises in December 1996 and committed $4.3 million to the fund. The Agreement of Limited Partnership, however, made no reference to whether or not the fund must invest in New Jersey companies, even though this was the purpose for appropriating the funds. As a result, only six of the seventeen companies in the portfolio as of March 31, 2001 were located in New Jersey. The other eleven companies were located in Connecticut, Maryland, New York, Pennsylvania, and Virginia. These are states that New Jersey is in direct competition with for start-up companies. It would seem prudent for the commission to prioritize investment in New Jersey companies instead of just investing.

Our review further noted that to provide funding the commission entered into an escrow agreement with Early Stage Enterprises. The commission placed $4.3 million into an escrow account from which Early Stage Enterprises has been drawing down funds as needed. The escrow agreement requires that Early Stage Enterprises remit to the commission, no less than once a year, all amounts earned on
escrowed funds. As of June 30, 2001, the commission had not received any interest payments even though the accumulated interest totaled $294,000.

**Recommendation**

We recommend Early Stage Enterprises focus its investments in New Jersey companies and the commission request payment of the interest earned to date on the escrowed funds.

**Auditee’s Response**

The Commission agreed with the recommendation that Early Stage Enterprise (ESE) should focus its investments on New Jersey companies as much as possible. As a limited partner in ESE, the Commission cannot request that ESE modify its current investment strategy; however, we do participate in an advisory capacity on the Board of ESE, and fully intend to emphasize our desire to see the fund focus on New Jersey-based companies.

At the time original ESE Limited Partnership was organized, there was concern that restricting the funds’s investments to only New Jersey companies would materially limit the General Partner’s ability to attract private-sector limited partner investors. While the resulting ESE portfolio mix had been less than ideal, from the Commission’s perspective, our $4.3 million investment has to date leveraged total ESE investment in New Jersey companies of $7.25 million. Put another way, the Commission contributed 16% of all the capital under management by ESE, but New Jersey companies have received 36% of all ESE-invested dollars to date.

With regard to interest earned on escrowed funds invested in ESE, the auditors’ review correctly noted that the escrow agreement stipulates annual remission of interest earnings to the Commission. In practice, ESE has provided annual documentation of the amount of such interest earnings, but the interest earnings have remained on deposit in the escrow account. It has been the Commission’s intent to use
these earnings, along with any proceeds from the sale of ESE assets, to seed the establishment of additional, or follow-on seed venture funds in New Jersey.

Nonetheless, we agree with the finding that the escrow agreement requires the remission of interest earnings to the Commission; accordingly, we will request that accumulated interest earnings through the end of ESE’s most recent fiscal year (date) be remitted to the Commission immediately, and that any additional interest earnings be remitted annually thereafter.

Early Stage Enterprise has proposed that the Commission use the interest earned on funds held in escrow to make a modest investment in a follow-on seed venture fund, “Early Stage Enterprises II.” The Commission has made no decision with regard to this request; however, any investment in additional seed venture funds by the Commission will be limited to funds that commit to focus their investment strategy on New Jersey companies.

Guidelines for business incubators should be enforced.

Picatinny Innovation Center

The Technology Business Incubator program was created to nurture start-up companies to a level of independence by providing them with low-cost space and technical assistance. Overall, the program is achieving its goals of encouraging the formation of new businesses and reducing the rate of new business failures. The commission’s 1999-2000 Annual Report states that the program has helped 104 companies graduate into commercial space since 1988.

Our review, however, disclosed that one of the seven state-funded incubators was not functioning as intended. The Picatinny Innovation Center (the
center) has tenants which are not start-up companies. The center, cosponsored by the Army’s Armament Research, Development and Engineering Center and the County College of Morris, is located at the Picatinny Arsenal in Dover, New Jersey. It began operations in September 1996 and has received $260,000 in state funding through fiscal year 2001. As of August 2001, six of the center’s fourteen tenants were military contractors and could not be considered start-up businesses. For example, one is a company which has been a tenant since September 1996 and had revenues of approximately $530 million in 2000.

We further noted that the center has not graduated a tenant in five years of operation. By contrast, another incubator which has been open for three years has already graduated three companies. One of the reasons for this situation is that Picatinny tenants must enter into a Cooperative Research and Development Agreement (CRADA) with the Army. The CRADA establishes the cooperative effort between the Army and the tenant and is the primary criteria for a company acquiring space in the center. As a result, the center rejects three or four companies per month due to the applicant’s inability to develop a CRADA with the Army. The CRADA requirement limits the center’s ability to support start-up businesses. It appears that the center has become a facility to house military contractors and the original intent to support start-up companies has become secondary.

**Recommendation**

We recommend that the commission discontinue funding the Picatinny Innovation Center unless it begins operating in accordance with the intent of the Technology Business Incubator program.

**Auditee’s Response**

The Commission agreed with the recommendation of the auditors concerning Picatinny Innovation Center.
As the audit report notes, the Picatinny Innovation Center (PIC) is severely constrained by the requirements of its host organization, Picatinny Arsenal. To attempt to eliminate this unacceptable situation, the Commission has been working with PIC along two tracks:

1. The management of PIC has committed to the development of an alternate, or additional, site for technology company incubation in the vicinity of Picatinny Arsenal. A feasibility study has been conducted, which has focused on a site in downtown Dover. Based on the results of this feasibility study, the PIC management and sponsor (County College of Morris) have proposed that the Commission partially underwrite the rehabilitation of a facility in Dover. Since this facility is not located within the Arsenal, an incubator at this location will not be subject to Army requirements concerning CRADAs and relationships with Army laboratories. This PIC proposal is currently being evaluated by the Commission, in the context of our ongoing incubator expansion program.

2. The Morris Area Development Council has been working with Picatinny Arsenal to develop a strategic plan for leveraging the Arsenal’s resources for overall economic development in the Dover-Sparta region. The Commission has supported this effort, through a grant which is partially underwriting the strategic planning effort. One of the major concepts being evaluated in this planning effort is a proposal to define a portion of the land currently held by Picatinny Arsenal as a special development zone, in which various economic activities could be pursued, without the restrictions typical to such activities on US Army property. As proposed, this special zone would include the current PIC
facility. If this proposal comes to fruition, it would eliminate most of the current Army restrictions on PIC tenants, and should allow PIC to operate in accord with the Commission’s general Incubator Best Practices.

The Commission intends to pursue both of the above potential solutions to the problems of the Picatinny Innovation Center. We are confident that one, or both, will result in conditions that permit the operation of a properly-functioning technology business incubator. Nonetheless, we agree with the finding of the auditors; unless the PIC can be configured to operate in accordance with the intent of our program, as reflected in our Best Practices, the Commission will discontinue its support for the Picatinny Innovation Center.