The Commonwealth of Massachusetts

AUDITOR OF THE COMMONWEALTH

ONE ASHBURTON PLACE, ROOM 1819
BOSTON, MASSACHUSETTS 02108

A. JOSEPH DeNUCCI
AUDITOR

TEL. (617) 727-6200

NO. 2003-0136-3A

INDEPENDENT STATE AUDITOR'S REPORT ON CERTAIN ACTIVITIES OF THE MASSACHUSETTS TECHNOLOGY DEVELOPMENT CORPORATION

JULY 1, 2001 TO FEBRUARY 28, 2003

OFFICIAL AUDIT REPORT

ARRIL 14, 2004

TABLE OF CONTENTS/EXECUTIVE SUMMARY

In accordance with Chapter 11, Section 12, of the Massachusetts General Laws, we conducted an audit of certain activities of the Massachusetts Technology Development Corporation (MTDC) for the period July 1, 2001 to February 28, 2003. Our review of MTDC was conducted to determine whether internal controls over administrative costs and expenses were adequate. In addition, we reviewed MTDC's progress in addressing the conditions noted in our prior report.

Our prior audit report noted that in 1998 MTDC had enhanced its compensation system by establishing a system of allocating to its employees a portion of net realized gains on MTDC's investments. The system, the Gain Share Awards Plan (GSAP), was designed to encourage retention of investment staff by allowing them to share in the success of the corporate portfolio. At the time of our prior review, it was noted that the two-year old GSAP plan favored senior executives. We therefore recommended that MTDC ensure that the GSAP be reasonable, warranted, and fiscally prudent.

Our follow-up review indicated that the GSAP continued to primarily benefit senior executives (President, Executive Vice-President, and Vice-President), who were credited $1,665,639 (81%) of the total $2,060,301 in GSAP awards made during fiscal years 1998 through 2002. Therefore, we question the accuracy of MTDC's assertion that the GSAP's purpose is to retain investment staff. We also found that although MTDC hired a compensation specialist to design the plan, no analysis of staff turnover or market compensation study was performed to demonstrate that the plan was warranted. Furthermore, Internal Revenue Service regulations indicate that income taxes on GSAP awards cannot be deferred until distribution (as originally believed when the plan was devised), which will compromise the GSAP as a retirement vehicle and make the plan difficult to administer. MTDC should re-evaluate the GSAP, giving due consideration to current employment and stock market conditions, present salary and benefit packages, taxation issues, and the plan's history of favoring senior executives. In its written response, MTDC stated the GSAP allocations to senior executives were justified because they are the employees most susceptible to recruitment away from MTDC. The current president also stated at the formal exit conference that he is much more involved in the investment portfolio than his predecessor, and that all three senior executives are also investment staff. MTDC stated that a performance-based plan helps MTDC compete for talent with similarly sized private venture capital firms and thus helps MTDC achieve its mission. Furthermore, MTDC stated the tax problems associated with the GSAP can be corrected fairly easily.

Our review of MTDC's administrative expenses revealed unnecessary and poorly documented expenses for a retirement reception ($30,320), meals and entertainment ($7,646), and meetings and conferences ($370). Chapter 40G of the General Laws provides that MTDC may do things that are "necessary and convenient" for conducting business and further enables MTDC to use funds for the "proper general expenses of the MTDC." However, because MTDC has not established guidelines, policies, and procedures regarding discretionary expenses, its documentation of disbursements was incomplete. Without such documentation, there is inadequate assurance that MTDC's administrative expenses are allowable, proper, and necessary. In its written response, MTDC agreed that the cost of the retirement party was excessive and indicated that it will not permit the occurrence of anything similar in the future despite the potential for significant networking opportunities. MTDC further stated that it has improved its expense documentation and that meeting and conference expenditures were justified because of the lack of adequate facilities at the MTDC office.

INTRODUCTION

Background

Chapter 497 of the Acts of 1978 established the Massachusetts Technology Development Corporation (MTDC), whose goal is to provide financial and other assistance to technology and start-up companies that have the potential to expand and generate new jobs and tax revenue. In calendar year 2002, legislation was passed to modify MTDC's charter to enable access to more private investment capital to better fulfill its mission of assisting the start-up and early expansion of technology companies in the Commonwealth. Although MTDC was initially funded by state and federal sources, its investments have allowed it to self-finance its operations since fiscal year 1988. MTDC is governed by an 11-member Board of Directors, eight of whom are appointed by the Governor from the private sector and three of whom are public officials. From its inception through February 28, 2003, MTDC has reported investing over $50 million in 108 companies that collectively have employed over 11,000 people.

Although MTDC's initial capital came from federal grants and state appropriations, it uses gains realized from past investments as the primary source of funds for further investments. The following summarizes MTDC's cumulative investment capital sources as of June 30, 2002.

Economic Development Administration of US Department of Commerce, Net of Start-Up Costs		$ 2,972,000
Commonwealth of Massachusetts		5,200,000
Realized Net Gains on Sales of Equity Securities Allocated to General Support Fund	$50,479,795	
Portion of Gains Used for General Support Activities	(14,422,429)	
Transfers to the Restricted for Investment Programs Fund		36,057,366
Total Funds Made Available for Investment		44,229,366
Realized Losses of Investments		(20,542,421)
Unrealized Gain/(Loss) on Portfolio Value		(290,726)
Restricted for Investment Programs Fund Balance		$23,396,219

In addition to the amounts available for investment as shown in the above schedule, MTDC manages two investment pools composed of funds from MTDC and private co-investors. The investment vehicle, known as the Commonwealth Fund, has two components: Program I and Program II. By statute, the investment criteria for capital managed under the Commonwealth Fund is less restrictive than those of MTDC's traditional programs.

As of June 30, 2002, each program had two co-investors who contributed a total of $2,164,337 to Program I and $2,222,649 to Program II. MTDC's capital contributions to the two programs, which totaled $9,913,892, is included in the "Restricted for Investment Programs Fund" balance of $23,396,219.

As of February 28, 2003, MTDC had exited or begun to exit its investments in 77 of its portfolio companies. After MTDC exits its investments from a portfolio company, it may then use the investment proceeds to invest in new companies.

Audit Scope, Objectives, and Methodology

Our audit covered the period July 1, 2001 to February 28, 2003 and was conducted in accordance with applicable generally accepted government auditing standards for performance audits.

The objectives of this audit were to:

- Review and analyze the adequacy of MTDC's internal controls over administrative costs and expenses.
- Examine MTDC's costs and expenses in the areas of travel, conferences, employee use of credit cards, salary and benefits, consultant payments, and equipment purchases and rentals and determine whether these costs are reasonable, allowable, and in compliance with applicable laws, rules, and regulations.
- Determine whether MTDC adequately addressed the condition noted in our prior audit report (No. 2000-0136-3) regarding the status of the Gain Share Awards Plan.

Our audit methodology included reviewing cash disbursement transactions and related records such as invoices, receipts, and expense reports; examining board minutes, compensation data, and related correspondence; and interviewing MTDC officials.

Based on our review we have concluded that, except for the issues addressed in the Audit Results section of this report, during the 20-month period ended February 28, 2003, MTDC maintained adequate internal controls and complied with applicable laws, rules, and regulations for the areas tested.

AUDIT RESULTS

1. PRIOR AUDIT RESULTS NOT RESOLVED – STATUS OF THE GAIN SHARE AWARDS PLAN

Our prior audit report (No. 2000-0136-3) noted that on June 11, 1998, the Board of Directors of the Massachusetts Technology Development Corporation (MTDC) approved a Gain Share Awards Plan (GSAP), which was designed to encourage the long-term retention of staff members by creating deferred financial incentives. This plan is funded by no more than 20% of net realized gains on MTDC's investments in a fiscal year, and all staff who complete 12 months of continuous service with MTDC are eligible to be considered in the plan. The President of MTDC determines which staff members shall be plan participants. In fiscal years 1998 and 1999, the GSAP allocation totaled $789,931, of which $655,932 (83%) was awarded to MTDC's President, Executive Vice-President, and Vice President.

Our prior report recommended that MTDC ensure that GSAP awards be reasonable, warranted, and fiscally prudent. We also recommended that, since proceeds from its investments have allowed MTDC to finance itself since fiscal year 1988, consideration be given to repaying the initial investment capital provided by the Commonwealth ($5,200,000) and federal government ($2,972,000).

In a letter dated February 12, 2001, MTDC stated that it believed that the GSAP was warranted, reasonable, and fiscally prudent. MTDC claimed that the GSAP was warranted because its main objective was to encourage the long-term retention of staff by creating deferred financial incentives based upon the realization of net gains. MTDC also stated that since 1984, it had hired and trained 20 new investment staff, but due to the possibility of greater rewards in the private sector, only four were still MTDC employees. MTDC added that its Board of Directors believed that an incentive plan such as the GSAP would help attract and retain investment professionals, which in turn would bolster MTDC's ability to secure additional private capital. MTDC's response further stated that in 1997 it retained an independent compensation specialist to devise a plan that was "fiscally sound, reasonable, and warranted" and based upon the successful performance of MTDC's investment portfolio. The plan, MTDC explained, was designed to compete with private venture capital compensation systems where managers are eligible to receive base salaries supplemented by bonuses and "carried interest" in the success of the investment portfolio. MTDC also stated that because it is not authorized to participate in the Commonwealth's Pension System, the GSAP was also a mechanism to build a retirement fund for the staff.

MTDC also claimed that, in addition to an incentive plan being necessary to retain staff, the GSAP was both reasonable and fiscally prudent, since it is premised upon the realization of net gains in a fiscal year, and if there are no gains, no awards are made. MTDC further stated that its Board of Directors sets the maximum allocation of net realized gains at 20%, an industry benchmark, and considers MTDC's overall financial condition in making a determination. Furthermore, MTDC stated, the payment of GSAP awards was limited by overall yearly compensation limits with excess amounts transferred to a reserve that is subject to forfeiture if an employee leaves within four years.

During our follow-up review, we obtained statistics on the GSAP since inception and other compensation information and evaluated assertions MTDC made in its written response.

GSAP award information for fiscal years 1998 through 2002 appears in the following table:

Fiscal Year	Net Gain/(Loss) on Investments	GSAP Allocation	GSAP Awarded to President, Executive Vice-President, and Vice President	Percentage of GSAP Awarded to President, Executive Vice–President, and Vice-President
1998	$9,297,038	$670,424	$555,600	83
1999	1,083,587	119,507	100,332	84
2000	4,937,810	725,431	609,606	84
2001	5,721,293	544,939	400,101	73
2002	(4,258,266)		-	-

As shown above, between fiscal years 1998 and 2001 $1,665,639 (81%) of the total $2,060,301 in GSAP awards were credited to the three highest-ranking and highest-paid executives at MTDC, even though between nine and 11 employees were eligible for awards. Through fiscal year 2001 MTDC's President and Vice-President had been senior executives at MTDC for 17 and 23 years, respectively, with most of the years of service occurring before the inception of the GSAP. Because of the disproportionate amount of GSAP benefits credited to the senior executives, we question MTDC's assertion that the plan is designed to attract and retain investment staff.

In addition to the GSAP plan, salaries at MTDC are supplemented by bonuses. The cumulative bonus pool is limited to 10% of MTDC's cumulative net realized gains, not to exceed 10% of the current years, net revenue. The following table shows the basic compensation (salary, GSAP awards, and bonuses) of MTDC's three senior executives for fiscal years 1998 through 2001.

	President				Executive Vice-President			
	1998	1999	2000	2001	1998	1999	2000	2001
Salary	$108,750	$115,000	$123,000	$123,000	$102,500	$110,000	$118,000	$122,000
GSAP	185,200	44,592	203,202	133,367	185,200	44,592	203,202	133,367
Bonus	34,000	34,500	47,600	36,900	33,000	33,000	45,600	35,400
Total	$327,950	$194,092	$373,802	$293,267	$320,700	$187,592	$366,802	$290,767

	Vice-President			
	1998	1999	2000	2001
Salary	$100,000	$100,000	$100,000	$115,000
GSAP	185,200	11,148	203,202	133,367
Bonus	30,000	11,250	40,000	30,000
Total	$315,200	$122,398	$343,202	$278,367

MTDC records show that from 1998 through 2001, MTDC paid $590,970 in bonuses, of which $411,250, or 70%, was paid to the three senior executives, as shown in the above table. The table also shows yearly salary increases were given in addition to the GSAP and bonuses. Although no GSAP awards or bonuses were paid in fiscal year 2002 and none were contemplated for fiscal fiscal year 2003, MTDC's Executive Vice-President received a $28,000 salary increase on October 1, 2001 (upon the retirement of the former MTDC President) and another $10,000 increase when he was promoted to President on November 1, 2002. We question whether such large compensation packages that favor senior executives are necessary, reasonable, and prudent for a quasi-public agency.

During our follow-up review, we reviewed many of the assertions that MTDC raised in its written response to justify the GSAP. MTDC stated that the GSAP was necessary because it does not participate in the Commonwealth's pension system. However, our review disclosed that MTDC provides its employees a Simplified Employee Pension Plan under which it makes payments to each individual employee's account in amounts equal to 10% of their gross annual salary, not to exceed $30,000 or the maximum amount allowable by federal law.

MTDC's prior response also stated that since MTDC's inception it has had a high turnover of investment staff members, which prompted its board and officers to devise a strategy (the GSAP) to increase staff retention. The Board of Directors concluded that the GSAP would help to keep experienced staff in place both to manage its assets derived from gains and to help attract additional private capital. MTDC stated that in the previous 16 years 16 staff members who left MTDC did so because of compensation issues. MTDC also stated that 16 investment staff leaving over a period of 16 years is excessive turnover.

MTDC's response indicated that in 1997 it engaged an independent compensation specialist to devise a compensation plan in which the GSAP was one component. The consultant produced a seven-page outline entitled "Compensation Design," which included the following compensation system:

- Base salary plus annual merit increases, plus annual competitive increases when market salaries exceed MTDC salaries by 15% or more, plus equity adjustments to salaries when internal salary comparisons require.

- Annual bonus based upon individual performance and paid as a percent of base salary commensurate with competitive practices in the financial services industry.

- Gain Share Awards Plan (GSAP) based upon each employee's roles and responsibilities, length of service, demonstrated long-term commitment, and past performance results.

However, the consultant's outline did not contain any data on compensation for comparable positions in the financial services industry or venture capital firms. The outline also did not analyze the reasons for MTDC staff turnover or whether the turnover was remarkable. Therefore, MTDC's assertion that the consultant's study showed that the GSAP plan was warranted is unsubstantiated.

The consultant also prepared the draft "Operating Guidelines" for the Gain Share Awards Plan, which established the following criteria:

- Determination of Gain Share Pool (President's recommendation of an amount not to exceed 20% of net realized gains to be presented to the board)

- Eligibility (staff members who have completed 12 months of service, meet performance standards, and achieve annual goals)

- Determination of Individual Gain Share Award Points (a point allocation schedule for each position based on role and responsibility, years of service, commitment and past performance i.e., Officers—100, Senior Associates—60, Associates—50, Managers—20, Support Staff—4)

- Determination of Individual Gain Share Awards (Gain share pool divided by total gain-share points multiplied by each employee's gain share points)

- Distribution of Gain Share Awards (payment of a gain share award that is limited to an amount, which when added to the base salary and annual bonus, does not exceed the applicable total cash "compensation maximums" established for specific positions: Officers $150,000, Senior Associates $120,000, Associates $100,000, Managers $80,000 and Support staff $45,000). Amounts reserved for more than four years are payable regardless of the total cash compensation maximum.

- Forfeiture of Earned Gain Share Awards (payment from the leaving participants reserve account as follows: 25% for five years or more and 50% for 10 years or more.

- Retirement, Death, or Disability from MTDC (retirees at the completion of a plan year to be paid a sum equal to the amount of the award had the employee not retired, plus any accumulated reserve. In the event of death, the award shall be paid out to the estate; and in the event of a disability, the award may be used to supplement disability payments after the employee has exhausted sick and vacation time.)

The GSAP was based upon the assumption that award allocations earned but not distributed would be tax-deferred (not taxable until distribution) and would thus enhance the GSAP as a retirement vehicle. On April 17, 2001 MTDC contemplated the distribution of the undistributed fiscal year 1998 GSAP reserve. On April 18, 2001, the Office of the State Auditor, by letter, questioned MTDC on whether GSAP allocations earned in years prior to distribution would comply with Internal Revenue Service regulations regarding taxability and establishing reserves. MTDC sought advice from the law firm that it had engaged on general corporate matters and the GSAP. The firm indicated that it was mistaken when it originally advised MTDC that GSAP allocations were taxable only upon distribution and that compensation shall be included in the gross income of the participant or beneficiary for the first taxable year in which there is no substantial risk of forfeiture of the rights to such compensation. Section 457f of the Internal Revenue Code states:

> *The rights of a person to compensation are subject to a substantial risk of forfeiture if such person's rights to such compensation are conditioned upon the future performance of substantial services by an individual.*

On June 18, 2001, MTDC engaged the tax department of its auditing firm to prepare amended individual tax returns for six GSAP recipients for calendar years 1998, 1999, and 2000 and to provide consulting services so that the GSAP would comply with current tax regulations. In addition, in September 2001, MTDC hired legal counsel to pursue a malpractice claim against the law firm that gave MTDC erroneous tax advice. A summary of the professional service costs and interest costs owed the state and federal governments related to the GSAP follows:

Tax Accounting Fees/Consulting	$36,800
Legal Fees	24,528
Interest on Taxes Due	37,508
Total	$98,836

MTDC stated that it believed that GSAP recipients should not have to bear the cost of the erroneous tax advice; therefore MTDC paid the fees to prepare amended returns and pay any interest due. Current employees took distributions from their GSAP reserve accounts to pay any taxes due. The tax accountants were successful in getting penalties waived and on November 27, 2002, the successor law firm obtained a $60,000 settlement from the lawyers who provided counsel on the GSAP, leaving MTDC with a net cost to date of $38,836 ($98,836 - $60,000).

Based upon the correct understanding of the GSAP's tax status, MTDC amended the plans "Operating Guidelines" on September 15, 2001 as follows:

> *Notwithstanding any guidelines stated above, any gain share award or portion of any award that is determined to be taxable, will be fully distributed in the year in which the tax liability arises. In addition, any gain share award reserves, or portion of reserves, that were determined to be taxable for Fiscal Year 1998, Fiscal Year 1999 and Fiscal Year 2000, will be fully distributed in 2001.*

It would appear that complying with the Internal Revenue Code would compromise the GSAP both as a retirement vehicle and as a method of having a "carried interest" in the success of the portfolio because building large reserves is incompatible with the inability to defer income. Also, applying the IRS requirements to the GSAP distributions and forfeiture provisions could become administratively burdensome.

While it is commendable that MTDC has tried to develop a performance-based incentive system including the GSAP, professionals such as accountants, lawyers, engineers and computer specialists who work in governmental or quasi-governmental entities typically earn less money than their private-sector counterparts. Because MTDC's compensation package includes annual salary reviews, bonus opportunities, and a simplified employee pension plan, it is questionable whether the GSAP is necessary.

During our current review, MTDC provided venture capital and private equity compensation surveys for 2001 and 2002 that showed higher salaries for private sector money managers; however, the ranges of assets under management were also much greater. Also, the respondents to the survey included many large, well-known and well-capitalized money-management firms (American Express, Bain Capital, Fidelity Ventures, Morgan Stanley Venture Partners and Warburg Pincus), which makes it difficult to draw valid conclusions and make decisions on comparability.

To date, the GSAP awards have favored the highest-paid executives with the longest tenure at MTDC, although the goal of the GSAP was to retain newly hired investment staff. Through June 30, 2003 GSAP cash distributions totaled $1,316,090, with $942,353 (72%) going to the current and former President of MTDC. Large allocations to senior management may not be justifiable because the entire corporation had only 11 employees at the time of creation of the GSAP and as of February 28, 2003 MTDC had only six employees, thus allowing a simplified management structure. The GSAP provides for no awards in a fiscal year when there are only net realized losses, but the individual reserve accounts are not penalized for these losses; therefore, employees can lock in net gains without sharing the burden of net losses. For example, in fiscal year 2002, when the net realized loss on investments was $4,258,266, none of this loss was allocated to the reserve accounts. Also, the GSAP was created on the assumption that awards would not be taxable until distributed, thus allowing both the possibility of growth through deferral and the timing of distributions when they were most tax advantageous to the employee. It would appear that taxability of awards would require more frequent distributions than originally contemplated, thus minimizing the GSAP's value as a vehicle encouraging long-term retention of employees.

Recommendation

MTDC should re-evaluate the necessity of the GSAP, giving due consideration to current employment and stock market conditions, distribution of awards favoring senior executives, present salary and benefit packages, and taxability of the awards.

Auditee's Response

The MTDC Gain Share Award Plan was approved by the Board of Directors on June 11, 1998. The Plan was designed to attract venture investment professionals and facilitate long-term retention of key staff members by creating deferred financial incentives based upon the realization of net gains from MTDC's investment portfolio.

The audit report notes that "between fiscal years 1998 and 2001 $1,665,639 (81%) of the total $2,060,301 in GSAP awards were credited to the three highest-ranking and highest-paid executives at MTDC" and, for that reason, questions whether "the plan is designed to attract and retain investment staff." The obvious defect in this reasoning is that the members of the investment staff who are the most experienced, and thus most susceptible to recruitment away from MTDC, are its executive officers. Those officers, by virtue of their decades of leadership in the venture capital industry and the extensive contacts they have developed there, are the investment staff who MTDC's Board wants most to retain.

The report did not indicate that the Plan's allocations to MTDC executives, $582,995 were forfeited to MTDC upon the departure from MTDC of its President, in September 2001, and successive Vice-Presidents, in April 1999 and September 2002.

The report is correct in pointing out the tax problem we encountered due to an oversight by the attorneys we had engaged as corporate counsel, to create a retirement-vehicle in which allocations would be taxable only upon distribution. As noted, MTDC as a result incurred unexpected expenses and pursued a malpractice claim against our former counsel which, in November 2002, was settled with the law firm's payment to MTDC of $60,000. MTDC's current corporate counsel believes that this structural problem in the plan's drafting can be corrected fairly easily, and the Board will engage counsel to make those corrections at the appropriate time. For now, the Plan's structural problems are effectively mooted by the absence of any gains.

We understand your concerns that this plan provides financial incentives which are too generous, given the balance of the staff's compensation packages and MTDC's identity as a quasi-public state agency. I can tell you that at the time this plan was developed we considered this issue very carefully. We also met with Mr. Charlie Baker, Secretary of Administration and Finance, to discuss our approach. Mr. Baker pushed back in a number of areas and we complied with his requirements. It has been our firm belief that when considering the 20 year track record of MTDC the value to our economic development programs is such that we should put in place a mechanism to attract and retain the best possible people to continue the MTDC mission. The key element of this plan is that it is a performance based plan. It is also under the scrutiny and control of the MTDC board who meet the strictest definition of independence. Among state agencies MTDC serves a unique economic development mission and has been uniquely successful in accomplishing its objectives. Since its inception, MTDC has invested more than $54 million in 114 Massachusetts companies, and has helped to create over 11,000

> *jobs while generating an internal rate of return of more than 17 percent. Since 1987, MTDC has been entirely self-funding, using gains from investments as a source of funds for operations and for further investments. Beginning in 1995, with the Commonwealth Fund Program, MTDC has actively recruited co-investors to the Corporation's mission of facilitating economic development for Massachusetts. Today, MTDC staff are busy meeting with prospective private co-investors while they raise yet a fourth fund that will focus exclusively on growing the Commonwealth's economic through targeted equity investing.*
>
> *Members of the MTDC team perform functions day-to-day that are indistinguishable from what their counterparts in private venture capital firms are doing. Yet the compensation paid to MTDC's investment staff members is, on average, fifty percent lower than that paid to similarly-situated, similarly-experienced investment professionals in similarly-sized private venture capital firms. MTDC staff, like professionals serving the Commonwealth in other capacities, is motivated in part by the ideal of public service.*
>
> *Like MTDC, other Commonwealth-connected entities that engage in specialized activities have had to offer compensation packages which, though not necessarily commensurate with what one sees in the private sector, are at least sufficient to attract and keep qualified professionals. With the benefit of twenty years of institutional knowledge, MTDC's Board of Directors decided in 1998 to implement the Gain Share Awards Plan as part of compensation package which would attract and retain the investment professionals that MTDC needs to continue to successfully accomplish its public policy objectives. MTDC's Board continues to believe that the Plan (as corrected for contingent tax liability) is fiscally sound, reasonable, and warranted.*

In addition, at the formal exit conference on March 4, 2004, the current president of MTDC stated that the three senior executives at MTDC are also investment staff and that he particularly is much more involved with investment decisions than the previous president.

Auditor's Reply

In its written response, MTDC questions the validity of our observation that the GSAP may not be achieving its goal of attracting and retaining investment staff because 81% of its awards were to Senior Executives (leaving only 19% for other staff). MTDC further explains that awards to senior executives are the most generous because these are the employees whom MTDC most wants to retain. However, in its February 21, 2001 response to our initial review of the GSAP (audit No. 2000-0136-3), MTDC stated that the GSAP was created to retain new staff members:

> *Since 1984, MTDC has hired and trained 20 new investment staff members. Today, only 4 of them are still employed by the Corporation and all 4 have been with MTDC for less than 3 years. This reality and the internally generated growth of MTDC assets, prompted the Board and officers to try to devise a strategy to increase retention.*

We understand that providing incentives for employees at all levels can increase motivation and encourage retention; however, MTDC's primary motivation (as evidenced by MTDC memoranda) in implementing the GSAP was to address the problem of training new staff only to have them recruited away by private venture capital firms. As our report states, MTDC senior executives already receive the highest salaries and bonuses, even before any GSAP awards are considered.

In its response, MTDC also notes that our finding does not recognize the forfeiture of $582,995 of GSAP awards upon the departure of three senior executives. During our review, we informed the CFO of MTDC that in accordance with the plan guidelines regarding forfeitures, $190,369 of awards probably should have been distributed rather than forfeited. The CFO agreed but could not determine why the $190,369 had not been distributed. Therefore, the forfeiture total should not be as large as cited in the response. Moreover, our report accurately differentiates between amounts awarded versus cash distributions. Furthermore, because IRS regulations discourage deferring awards, future distributions will likely be more frequent, resulting in fewer forfeitures.

We commend MTDC for aggressively seeking a settlement regarding the malpractice claim and the professional and constructive tone it evidenced throughout our fieldwork and in its written response. We respect MTDC's experience in venture capital and recognize that it has latitude to experiment with compensation-related incentives. However, various issues cited in our report—such as the connection between compensation and turnover, appropriateness of investment firm salary comparisons, and overall compensation and tax administration—need additional study and review by MTDC.

2. UNREASONABLE AND INADEQUATELY DOCUMENTED EXPENSES TOTALING $38,336

MTDC's purpose is to provide financial and other assistance to innovative technology-based enterprises in Massachusetts that have the potential to expand and generate new jobs and tax revenues. However, our review of MTDC administrative costs revealed expenses for meals, meetings, conferences, and a reception that were not consistent with MTDC's objectives, as shown in the following table:

Category	Expenses Tested Number	Expenses Tested Amount	Unreasonable Expenses Number	Unreasonable Expenses Amount
Retirement Reception	1	$30,320	1	$30,320
Meals and Entertainment	24	20,987*	14	7,646
Meetings and Conferences	28	5,286	3	370
Total	53	$56,593	18	$38,336

* Note: We tested all "Meals and Entertainment" expenses over $100.

A reception for MTDC's retiring President was held on October 18, 2001 at the federal courthouse and cost $30,320, including a gift. MTDC invited 330 guests, of which approximately 200 attended. MTDC paid the caterer $11,727 for the following items:

Hors D'oeuvres	$3,450
Stationary Food Displays (Distinctive dips, cheese, fruits, and assorted tapas)	3,000
Beverage Service (200 drink tickets plus one-day liquor license of $375)	1,175
Rental of Glassware for Bar	750
Service (Bartenders, waiters, and culinary staff for six hours)	2,082
Rentals (Table, linens, coat racks, including pick-up and delivery)	920
Other Miscellaneous Expenses	350
	$11,727

MTDC also paid an event management/public relations firm $10,374 (included in the total $30,320 expense) for the concept and development of the retirement celebration. The event management company promised a fitting tribute that would reflect the importance of the President's 17-year tenure. The company indicated that its services would provide MTDC staff "peace of mind" and allow them to enjoy the evening and spend time with the honored guest. The company selected the location, caterer, jazz quartet, and audiovisual company. The company also designed the invitation, menu, and event program (handout); provided a line drawing of the President for display; and produced a PowerPoint presentation using photographs of the President's life programmed to music. Some of the costs incurred (paid to other vendors) by the event management company and passed on to MTDC appear below:

Original Line Drawing of President, Including Frame	$ 216
Invitation Design	500
Business Cards	140
Photography and Audio Services Related to PowerPoint Presentation	518
	$1,374

The event management firm did not provide invoices for the above out-of-pocket costs nor did MTDC request such documentation. The costs of $1,374 plus the fee of $9,000 equals the $10,374 paid to the event management company.

In addition to the $10,374 paid to event management firm and the $11,727 paid to the caterer, MTDC incurred the following costs associated with the retirement celebration:

• Use of Federal Courthouse	$3,321
• Design Fees and Photography	$2,459
• Jazz Quartet	$550
• Printing of Event Program	$432
• PowerPoint Presentation	
Computer Technician	
a) Preparation: 4 hours x $60/hr	$240
b) Presentation: 4 hours x $90/hr (Overtime rate)	$360
c) Rental of Microphone	$70
• Aero Pocket Watch—Gift for President	$787

MTDC could not provide invoices for the rental of the courthouse ($3,321) or for the design fees and photography ($2,459). We believe that spending over $30,000 for a retirement party does not conform with MTDC's stated mission of financing technology start-up companies that could attract private co-investment and create new jobs.

In addition to the retirement reception, we question costs of $7,646 classified by MTDC as "meals and entertainment" and $370 classified as "meetings and conference." The $7,646 consists of $6,031 for board meeting costs and $1,615 for staff luncheons, including a gift. Our review of available documentation showed that costs per board meeting, as follows:

Date	Location	Cost	Attendees: MTDC Staff	Attendees: MTDC Board Members	Attendees: Company Representatives
November 16, 2000	The Sheraton, Lexington	$ 623	8	5	5
December 14, 2000	The Sheraton, Lexington	643	8	5	6
July 26, 2001	The Marriott, Burlington	839	9	7	6
September 13, 2001	The Marriott, Burlington	641	9	8	1
October 18, 2001	The Marriott, Burlington	696	9	9	1
November 15, 2001	The Marriott, Burlington	641	7	9	1
December 13, 2001	The Marriott, Burlington	641	9	8	5
May 16, 2002	The Westin, Waltham	768	7	10	1
June 20, 2002	The Westin, Waltham	539	4	10	2
		$6,031			

All the hotel charges included breakfast or lunch and, depending on the hotel and business conducted, may have included telephone lines and speakerphones for conference calls ($150), room rental fees or set-up fees ($300-$400), and use of audio-visual equipment ($90). We question the need to spend more than $6,000 at hotels when MTDC has two large conference rooms and adequate telephone systems at its Boston office. MTDC informed us that it holds the meetings at hotels near Route 128 because many of its clients and board members are affiliated with high-technology companies located there. MTDC also noted that Chapter 40G, Section 2, of the General Laws provides that each board member shall be entitled to reimbursement for actual and necessary expenses in performing their duties, so MTDC would have to pay Boston parking rates for board members to attend meetings. However, our review of board member business addresses showed that five of the 10 board members (one vacancy) worked in Boston or Cambridge. The other attendees at the board meetings were MTDC staff and company representatives.

In addition, our review of the remaining items classified as “meals and entertainment” ($1,615) and “meetings and conferences” ($370) disclosed the following items that lacked explanations of business purpose and did not list attendees or their company affiliations: luncheons ($1,819), brownies and cookies ($66), wine tasting ($50), and gift certificate for a retiring employee ($50).

Our audit indicated that MTDC has not established policies, procedures, and documentation requirements for expenses incurred for meetings, conferences, receptions, and luncheons.

Payments are made in some cases without documentation as to attendees and the reasons for the disbursement. MTDC's enabling legislation Chapter 40G, Section 3, gives MTDC the power to "make contracts and execute all instruments necessary or convenient for the carrying on of its business." Moreover, Section 4 provides that "All appropriations, grants, contractual reimbursements and all other funds designated for this purpose and the proceeds of all investments made pursuant to the preceding sentence, may be used to pay for the proper general expenses of the MTDC." Without appropriate documentation and policies it is difficult to ascertain whether disbursements made by MTDC are "necessary or convenient" or are for a "proper general expense."

Recommendation

MTDC should develop clear and concise policies and procedures for meetings, meals, and conferences that:

- Clearly show the business purpose, attendees, and correlation to MTDC's mission.
- Establish spending limits beyond which prior approval is required by MTDC's President.
- Consider the necessity of using MTDC funds to cover the costs of retirement parties, going-away luncheons, and gifts.
- Utilize the facilities at the MTDC Boston office to the greatest extent possible.
- Review contracts and invoices more carefully for compliance with terms and reasonableness.

Auditee's Response

The report concludes that MTDC should not have spent $30,000 in October 2001 on a reception for its retiring President. While the event was not only meant to honor the President after seventeen years of service, but was also a networking event for MTDC staff and the principals of MTDC portfolio companies, past and present, the Board of Directors agrees that the final cost was excessive. In planning the event, costs unfortunately grew incrementally. With new management now in place and the benefit of the lessons learned from planning the reception, MTDC will not permit the occurrence of anything similar.

The report also questions expenditures during the period audited for board meeting costs ($6,031), "meals and entertainment" ($1,615), and "meetings and conferences" ($370). The money spent on meetings of the Board of Directors was necessary because the conference room at MTDC's offices is simply too small to accommodate those—often more than twenty people—who attend Board meetings. And holding the meetings at hotels near Route 128 is, in fact, more convenient than coming to Boston for almost all *of the Directors and other attendees. In any event, because of the usual number of attendees (and the inadequacy of the conference room in MTDC's offices) an off-site venue would have to be rented even if the meetings were held in Boston. The expenditures classified as "meals and entertainment" and "meetings and conferences" were all related to various networking events over the years and, in accord with the report's recommendations, are now better documented than they were during the audited period.*

Auditor's Reply

MTDC's lease for office space, in effect during our fieldwork, expired on May 31, 2003. MTDC was considering renting other office space at that time. If MTDC considers the current facilities inadequate, it should determine the cost effectiveness of leasing facilities with a more favorable location and larger conference rooms versus using hotel space on an as-needed basis.

We attended an exit conference with MTDC's President and CFO, on March 4, 2004, at its new Boston location. We observed that the new office suite was much smaller than the previous one and had less conference room space.