

SRI International

**Reports of Financial Statements
and Schedule of Expenditures of State Financial
Assistance in Accordance with Chapter 10.650
Rules of the Auditor General
Year Ended December 25, 2010**

SRI International
Reports on State Financial Assistance in Accordance with
Chapter 10.650 Rules of the Auditor General
Year Ended December 25, 2010

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Report of Independent Certified Public Accountants

To the Board of Directors
SRI International

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of activities and unrestricted net assets and cash flows present fairly, in all material respects, the financial position of SRI International and its subsidiaries ("SRI") as of December 25, 2010 and December 26, 2009, and the changes in their net assets and their cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of SRI's management. Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In accordance with *Government Auditing Standards*, we have also issued our report dated April 29, 2011 on our consideration of SRI's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts and grant agreements and other matters for the year ended December 25, 2010. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

Our audit was conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The accompanying Schedule of Expenditures of State Financial Assistance, for the year ended December 25, 2010, is presented for purposes of additional analysis as required by Chapter 10.650, *Rules of Auditor General*, Florida Single Audit Act, Audits-Nonprofit and For-Profit Organizations, and is not a required part of the basic financial statements. As described in Note 1 to the Schedule of Expenditures of State Financial Assistance, the accompanying schedule was prepared on the cash basis, which is a comprehensive basis of accounting other than accounting principles generally accepted in the United States of America. Such information has been subjected to the auditing procedures applied in the audit of the financial statements and, in our opinion, is fairly stated in all material respects, on the basis of accounting described in Note 1, in relation to the financial statements taken as a whole.

A handwritten signature in black ink that reads "PricewaterhouseCoopers LLP".

April 29, 2011

SRI International and Subsidiaries
Consolidated Balance Sheets
December 25, 2010 and December 26, 2009

	December 25, 2010	December 26, 2009
Assets		
Current assets		
Cash and cash equivalents	\$ 91,754,000	\$ 56,322,000
Restricted cash and cash equivalents	9,039,000	998,000
Investments	11,056,000	10,968,000
Receivables (including contractual retentions and deferred billings: \$66,181,000 in 2010 and \$68,756,000 in 2009; less allowance for uncollectible accounts: \$3,189,000 in 2010 and \$4,575,000 in 2009)	100,686,000	101,359,000
Inventory	2,005,000	1,744,000
Prepaid expenses and other assets	7,518,000	5,395,000
Total current assets	222,058,000	176,786,000
Property and equipment, net	109,729,000	102,907,000
Other noncurrent assets, net	8,370,000	14,271,000
Total assets	\$ 340,157,000	\$ 293,964,000
Liabilities and Unrestricted Net Assets		
Current liabilities		
Accounts payable and accrued expenses	\$ 80,016,000	\$ 69,075,000
Line of credit	10,962,000	-
Client advances and credits	14,544,000	16,971,000
Current portion of capital lease obligations	404,000	381,000
Current installments of long-term debt	35,149,000	21,448,000
Total current liabilities	141,075,000	107,875,000
Long term portion of capital leases	2,682,000	3,086,000
Long-term debt, excluding current installments	3,026,000	5,738,000
Other noncurrent liabilities	18,167,000	31,487,000
Total liabilities	164,950,000	148,186,000
Commitments and contingencies		
Unrestricted net assets	175,207,000	145,778,000
Total liabilities and unrestricted net assets	\$ 340,157,000	\$ 293,964,000

The accompanying notes are an integral part of these consolidated financial statements.

SRI International and Subsidiaries
Consolidated Statements of Activities
Years Ended December 25, 2010 and December 26, 2009

	December 25, 2010	December 26, 2009
Project revenue	\$ 494,982,000	\$ 459,477,000
Royalty revenue	7,771,000	9,590,000
Net revenue	<u>502,753,000</u>	<u>469,067,000</u>
Direct project costs	<u>(291,606,000)</u>	<u>(265,245,000)</u>
Excess of net revenue over direct project costs	<u>211,147,000</u>	<u>203,822,000</u>
Indirect expenses		
Salaries, wages, and benefits	130,382,000	129,787,000
Property and equipment	41,065,000	39,546,000
Materials, services, travel, and other	34,789,000	35,369,000
Internal research programs	7,958,000	6,465,000
Total indirect expenses	<u>214,194,000</u>	<u>211,167,000</u>
Other income (expense)		
Interest income	398,000	562,000
Interest expense	(805,000)	(468,000)
Stanford University separation expense	(1,791,000)	(1,647,000)
Realized gains on investments	29,865,000	3,901,000
Restructuring costs	(4,768,000)	-
Other, net	3,714,000	5,958,000
Total other income (expense), net	<u>26,613,000</u>	<u>8,306,000</u>
	23,566,000	961,000
Equity in (loss) income of affiliates	(678,000)	(2,030,000)
Unrealized gains (losses) on investments	465,000	1,684,000
Income (loss) before income taxes	<u>23,353,000</u>	<u>615,000</u>
Income tax expense	<u>6,076,000</u>	<u>(523,000)</u>
Change in unrestricted net assets	29,429,000	92,000
Unrestricted net assets - beginning of year	<u>145,778,000</u>	<u>145,686,000</u>
Unrestricted net assets - end of year	<u>\$ 175,207,000</u>	<u>\$ 145,778,000</u>

The accompanying notes are an integral part of these consolidated financial statements.

SRI International and Subsidiaries
Consolidated Statements of Cash Flows
Years Ended December 25, 2010 and December 26, 2009

	December 25, 2010	December 26, 2009
Cash flows from operating activities		
Change in unrestricted net assets	\$ 29,429,000	\$ 92,000
Adjustments to reconcile change in unrestricted net assets to net cash provided by operating activities		
Depreciation and amortization	16,179,000	13,890,000
Provision for doubtful accounts	(969,000)	1,149,000
(Gain) loss on investments	(30,464,000)	(5,585,000)
Equity in affiliates, net	678,000	926,000
Loss on sale of property and equipment	(19,000)	527,000
Deferred tax expense	(5,513,000)	159,000
Changes in operating assets and liabilities		
Restricted cash and cash equivalents	(8,041,000)	1,198,000
Receivables, net	1,660,000	(5,643,000)
Inventory	(261,000)	2,902,000
Prepaid expenses and other assets	(1,717,000)	(426,000)
Other assets, net	782,000	1,005,000
Accounts payable and accrued expenses	10,777,000	51,000
Client advances and credits	(2,427,000)	(5,954,000)
Other noncurrent liabilities	(4,216,000)	2,807,000
Net cash provided by operating activities	<u>5,878,000</u>	<u>7,098,000</u>
Cash flows from investing activities		
Cash outflow and subsequent payments for acquisition of QCL	-	(250,000)
Purchase of investments	(225,000)	(1,871,000)
Sale and maturity of investments	31,906,000	4,319,000
Capital expenditures	(24,032,000)	(17,865,000)
Proceeds from sale of subsidiary	-	749,000
Proceeds from sale of property and equipment	210,000	31,000
Net cash used in investing activities	<u>7,859,000</u>	<u>(14,887,000)</u>
Cash flows from financing activities		
Proceeds from issuance of long-term debt	15,753,000	-
Principal payments of long-term debt	(3,950,000)	(5,024,000)
Payments under capital lease	(705,000)	(621,000)
Change in bank overdraft	(365,000)	1,893,000
Proceeds from notes payable to bank, net	10,962,000	-
Net cash (used in) provided by financing activities	<u>21,695,000</u>	<u>(3,752,000)</u>
Net (decrease) increase in cash and cash equivalents	35,432,000	(11,541,000)
Cash and cash equivalents		
Beginning of year	<u>56,322,000</u>	<u>67,863,000</u>
End of year	<u>\$ 91,754,000</u>	<u>\$ 56,322,000</u>
Supplemental disclosures of cash flow information		
Cash paid during the year for		
Interest, net of amount capitalized	\$ 269,000	\$ 391,000
Income taxes	-	238,000
Noncash transactions		
Noncash capital expenditures	-	533,000
Insurance claims paid to claimants directly by insurance company	4,299,000	-

The accompanying notes are an integral part of these consolidated financial statements.

SRI International and Subsidiaries

Notes to Consolidated Financial Statements

December 25, 2010 and December 26, 2009

1. Nature of Organization and Summary of Significant Accounting Policies

Description of Business

SRI International ("SRI"), a nonprofit corporation, is one of the largest contract research technology development and consulting organizations in the world. SRI's main business units, together with its consolidated subsidiaries, provide scientific research, development, and technology/management consulting to businesses and governments worldwide. The U.S. government, foreign governments, and some of the world's largest companies have been long-standing, major clients of SRI. It serves these clients by providing an extremely wide range of scientific and professional expertise. Work encompasses the entire cycle of research and development – from basic research to problem solving to the full spectrum of engineering sciences; systems engineering; physical and life sciences; social, economic, and political science; and business management consulting and market/technology studies and analysis. SRI is headquartered in Menlo Park, California, with major facilities in Arlington and Harrisonburg, Virginia; State College, Pennsylvania; Princeton, New Jersey; St. Petersburg, Florida and other offices throughout the United States and overseas.

SRI and its subsidiary, SRI Holdings, use a fiscal year that ends on the last Saturday in December. The fiscal years ended December 25, 2010 and December 26, 2009 included 52 weeks of operations. SRI's other subsidiaries; Sarnoff Corporation ("Sarnoff") and Averatek Corporation ("Averatek") use a fiscal year that ends on December 31.

Principles of Consolidation

The accompanying consolidated financial statements have been prepared on the accrual basis of accounting in accordance with accounting principles generally accepted in the United States of America and include the accounts of SRI and its wholly owned subsidiaries, SRI Holdings, Sarnoff and subsidiary Averatek in which SRI has a majority or controlling interest. All material intercompany balances and transactions have been eliminated in consolidation.

Investments in other affiliated companies over which SRI has significant influence are accounted for on the equity method and are reflected as other noncurrent assets.

Unrestricted Net Assets

Revenues are reported as increases in unrestricted net assets unless use of the related assets is limited by donor-imposed restrictions. To date, SRI has not received significant donor contributions and therefore all net assets are considered unrestricted. Expenses are reported as decreases in unrestricted net assets. Gains or losses on investments and other assets or liabilities are reported as increases or decreases in unrestricted net assets unless their use is restricted by explicit donor stipulation or by law.

Measure of Operations

SRI considers all revenues and expenses related to operations except equity income or loss from investee companies and unrealized gains or losses from investments.

Revenue

Project revenue for services performed is recognized based upon applicable input or output measures including principally costs incurred under cost reimbursable contract arrangements. Periodic reviews are made as work progresses and a provision for uncollectible project revenue is made for any estimated unrecoverable amounts or estimated losses. Certain of the project revenue arrangements provide for contractual restrictions such as ceilings on rates and costs.

SRI International and Subsidiaries

Notes to Consolidated Financial Statements

December 25, 2010 and December 26, 2009

SRI receives royalties on certain technology on which it holds patents or copyrights. Royalty income, net of amounts shared with inventors and employees, is recorded when due under the applicable technology transfer agreements and when collectibility is reasonably assured.

Cash Equivalents

Cash equivalents consist of short-term highly liquid investments with an original maturity of three months or less when purchased.

Restricted Cash and Cash Equivalents

Restricted cash and cash equivalents consist primarily of funds that are contractually restricted for certain purposes, including unspent bond proceeds, funds deposited for future bond redemption and unspent funds from a contract with the State of Florida that are contractually restricted for certain purposes.

Investments

Investments in equity securities with readily determinable fair values and all investments in debt securities are reported at fair value based upon quoted market prices. Nonmarketable securities are valued at cost when received and subsequently may be impaired to the extent that the fair value is lower than cost.

Fair Value of Financial Assets and Liabilities

Accounting Standards Codification ("ASC") 820, *Fair Value Measurements*, defines fair value as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. ASC 820 also establishes a fair value hierarchy which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The standard describes three levels of inputs that may be used to measure fair value:

- Level 1 - Quoted prices in active markets for identical assets or liabilities.
- Level 2 - Observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities.
- Level 3 - Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities.

SRI's financial instruments include cash and cash equivalents, receivables, investments, accounts payable, client advances and credits and long-term debt.

The carrying amounts of cash and cash equivalents, receivables, accounts payable, and client advances and credits approximate fair value because of the short-term maturity of these financial instruments. The carrying value of SRI's long-term debt approximates fair value because interest rates reflect current market rates offered by lending institutions for loans with similar terms to companies with comparable credit risk.

SRI International and Subsidiaries

Notes to Consolidated Financial Statements

December 25, 2010 and December 26, 2009

Credit Risk

The majority of revenues for SRI are generated from U.S. government contracts with a variety of government agencies. Other revenues consist primarily of contracts with private entities and foreign governments which are widely dispersed. While SRI believes there is minimal credit risk given the nature of its customers, significant changes in levels of federal research funding could impact SRI.

Inventory

Inventory consists of supplies used in research activities and project related equipment and is valued at the lower of cost or market, cost being determined by a method that approximates the first-in, first-out method.

Property and Equipment

Purchased property and equipment are recorded at cost. Donated property and equipment are recorded at their fair value at date of gift.

Depreciation of property and equipment is provided over the estimated useful lives of the respective assets. Buildings and improvements are depreciated over various lives, ranging from 10 to 40 years, principally by the straight-line method. Equipment is depreciated over various lives, ranging from 3 to 20 years, by the straight-line method. Leasehold improvements are amortized over shorter of the terms of the respective leases by the straight-line method or their economic life.

Property and equipment under capital leases is recorded at the present value of the minimum lease payments at the inception of the leases and is amortized on the straight-line method over the shorter of the lease term or the estimated useful life of the equipment. The amortization of assets recorded under capital leases is included in depreciation and amortization expense in the accompanying consolidated statement of operations. Interest costs incurred on borrowed funds during the period of construction of capital assets is capitalized as a component of the cost of acquiring these assets.

Accumulated amortization (included in accumulated depreciation) associated with equipment held under capital leases was \$448,000 and \$267,000 at December 25, 2010 and December 26, 2009, respectively. During 2010 and 2009, SRI capitalized approximately \$20,000 and \$7,000 respectively, of interest expense related to various construction projects. Repairs and maintenance expenditures are expensed as incurred.

Intangibles

External incremental costs of obtaining patents on SRI's intellectual property are expensed as incurred due to the inability to reasonably forecast future cash flows from the patents developed.

SRI amortizes its goodwill and intangibles over its estimated life. In addition, SRI evaluates goodwill and intangibles for impairment annually or whenever events or changes in circumstances indicate that goodwill might be impaired.

Impairment of Long-Lived Assets

Long-lived assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to future net cash flows expected to be generated by the asset. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the

SRI International and Subsidiaries

Notes to Consolidated Financial Statements

December 25, 2010 and December 26, 2009

assets exceeds the fair value of the assets. There were no impairment losses for the years ended December 25, 2010 and December 26, 2009.

Client Advances and Credits

Client advances and credits represent funds received from customers in advance of performing services and recording revenue.

Asset Retirement Costs and Obligations

Asset retirement costs and obligations ("AROs") are recognized as liabilities when incurred, with initial measurement at fair value. These liabilities are accreted to full value over time through charges to income. In addition, an asset retirement cost is capitalized as part of the related asset's carrying value and is depreciated over the asset's useful life. Estimated AROs of \$1,470,000 and \$1,616,000 are included in other noncurrent liabilities in the consolidated balance sheets at December 25, 2010 and December 26, 2009, respectively.

Income Taxes

SRI is a nonprofit corporation and is tax exempt under Section 501 (c)(3) of the Internal Revenue Code. Activities that generate unrelated business income, as defined by the Internal Revenue Service, are subject to income taxes. SRI Holdings, Averatek and Sarnoff are taxable corporations. Income taxes are accounted for under the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date.

Use of Estimates

The preparation of the consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results differ from those estimates.

Reclassifications

Certain amounts in the consolidating balance sheet in the 2009 financial statements have been reclassified to conform to the 2010 financial statement presentation. Such reclassifications had no impact on previously reported total consolidated assets, liabilities, unrestricted net assets, or the statements of activities and cash flows.

SRI International and Subsidiaries
Notes to Consolidated Financial Statements
December 25, 2010 and December 26, 2009

2. Investments

Investments at fair value as of December 25, 2010 and December 26, 2009 consisted of the following:

	December 25, 2010	December 26, 2009
Nuance Communications common stock	\$ 11,030,000	\$ 9,985,000
Intuitive Surgical common stock	26,000	612,000
Other equity securities and certificates of deposit	-	371,000
	<u>\$ 11,056,000</u>	<u>\$ 10,968,000</u>

Net gains (losses) on investments consisted of the following:

	December 25, 2010	December 26, 2009
Unrealized		
Nuance Communications common stock	\$ 1,051,000	\$ 1,869,000
Intuitive Surgical common stock	(586,000)	(180,000)
Other equity securities	-	(5,000)
	<u>465,000</u>	<u>1,684,000</u>
Realized		
Siri common and preferred stock	28,966,000	-
Nuance Communications common stock	641,000	3,025,000
Intuitive Surgical common stock	422,000	873,000
Other equity securities	(30,000)	3,000
	<u>29,999,000</u>	<u>3,901,000</u>
	<u>\$ 30,464,000</u>	<u>\$ 5,585,000</u>

The following table presents information about SRI's investments that are measured at fair value on a recurring basis as of December 25, 2010 and December 26, 2009:

	December 25, 2010		
	Level 1 (Quoted prices in Active markets)	Level 2 (Observable inputs other than Level 1)	Total
Assets			
Common stock	\$ 11,056,000	\$ -	\$ 11,056,000
Certificates of deposit	-	-	-
	<u>\$ 11,056,000</u>	<u>\$ -</u>	<u>\$ 11,056,000</u>

SRI International and Subsidiaries
Notes to Consolidated Financial Statements
December 25, 2010 and December 26, 2009

	December 26, 2009		Total
	Level 1 (Quoted prices in Active markets)	Level 2 (Observable inputs other than Level 1)	
Assets			
Common stock	\$ 10,597,000	\$ -	\$ 10,597,000
Certificates of deposit	-	371,000	371,000
	<u>\$ 10,597,000</u>	<u>\$ 371,000</u>	<u>\$ 10,968,000</u>

3. Property and Equipment

Property and equipment as of December 25, 2010 and December 26, 2009 consisted of the following:

	December 25, 2010	December 26, 2009
Land and improvements	\$ 18,439,000	\$ 21,402,000
Buildings	162,434,000	171,850,000
Equipment	138,979,000	150,604,000
Leasehold improvements	6,067,000	5,185,000
Construction-in-progress	7,994,000	8,979,000
	<u>333,913,000</u>	<u>358,020,000</u>
Less: Accumulated depreciation and amortization	<u>(224,184,000)</u>	<u>(255,113,000)</u>
	<u>\$ 109,729,000</u>	<u>\$ 102,907,000</u>

Depreciation and amortization expense for the years ended December 25, 2010 and December 26, 2009 was \$15,801,000 and \$13,890,000, respectively. Depreciation expense for the years ended December 25, 2010 and December 26, 2009 was \$15,105,000 and \$13,101,000, respectively.

As of December 25, 2010, SRI held \$40,634,000 of fully depreciated assets.

SRI International and Subsidiaries
Notes to Consolidated Financial Statements
December 25, 2010 and December 26, 2009

4. Other Noncurrent Assets

Other noncurrent assets as of December 25, 2010 and December 26, 2009 consisted of the following:

	December 25, 2010	December 26, 2009
Contractual retention and fee withhold receivable	\$ 5,505,000	\$ 5,651,000
Goodwill	221,000	355,000
Other intangible assets, net	921,000	921,000
Investments in affiliates, net	272,000	1,252,000
Insurance receivable	900,000	5,084,000
Other	551,000	1,008,000
	<u>\$ 8,370,000</u>	<u>\$ 14,271,000</u>

In April 2010, SRI finalized the sale of its equity investment in SIRI. SRI received proceeds of approximately \$33,400,000 (net of distributions to employees in accordance with its royalty and equity sharing policy), resulting in a gain of \$28,832,000.

5. Accounts Payable and Accrued Expenses

Accounts payable and accrued expenses as of December 25, 2010 and December 26, 2009 consisted of the following:

	December 25, 2010	December 26, 2009
Accounts payable	\$ 35,366,000	\$ 30,926,000
Accrued payroll, vacation and other employee related accruals	31,870,000	22,756,000
Bank overdraft	4,792,000	5,157,000
Stanford separation expense (Note 12)	1,791,000	1,647,000
Accrued insurance	2,881,000	3,165,000
Other	3,316,000	5,424,000
	<u>\$ 80,016,000</u>	<u>\$ 69,075,000</u>

SRI International and Subsidiaries
Notes to Consolidated Financial Statements
December 25, 2010 and December 26, 2009

6. Long-Term Debt

Long-term debt as of December 25, 2010 and December 26, 2009 consisted of the following:

	December 25, 2010	December 26, 2009
California Infrastructure and Development Bank Revenue Bond Series 2003A Tax-exempt Variable Rate Demand Revenue Bonds ("Series 2003A Bonds"), payable through 2028 interest at 0.33% at December 25, 2010 and 0.24% at December 26, 2009	\$ 20,268,000	\$ 20,941,000
California Infrastructure and Development Bank Revenue Bond Series 2010 Tax-exempt Variable Rate Demand Revenue Bonds ("Series 2010 Bonds"); interest at 0.33% at December 25, 2010	14,486,000	-
Sarnoff credit facility with bank collateralized by substantially all Sarnoff's assets available through September 2011 Interest was 5.5% at December 25, 2010 and December 26, 2009, respectively	-	3,250,000
Note payable from Sarnoff to bank, collateralized by equipment, interest at 7.75% on \$138,000 and interest at 8.5% on \$63,000, payable through August 2011.	201,000	525,000
Notes payable from Averatek to CSL interest at 4.73% on \$643,000, 3.2% on \$652,000, 2.87% on \$288,000, 2.66% on \$70,000, 2.64% on \$47,000, 2.82% on \$200,000, 2.7% on \$259,000 1.59% on \$100,000, and 1.53% on \$235,000	2,494,000	1,560,000
Notes payable from Averatek to bank, collateralized by equipment, interest at 5.99% payable in monthly installments through 2014	726,000	910,000
Total long-term debt	38,175,000	27,186,000
Less: Current installments	35,149,000	21,448,000
Long-term debt, excluding current installments	\$ 3,026,000	\$ 5,738,000

Series 2003A Bonds

In September 2003, the California Infrastructure and Development Bank (the "Infrastructure Bank") issued \$25 million Tax-Exempt Variable Rate Demand Revenue Bonds (the "Series 2003A") on behalf of SRI. The proceeds from this bond issuance were used for the financing or refinancing of the acquisition, construction, installation, improvement, renovation, remodeling, replacement, furnishing and equipping of certain research facilities owned and operated by SRI and located at SRI's main campus at Menlo Park. Series 2003A bonds are subject to optional and mandatory sinking fund redemption and optional and mandatory tender for purchase at any time they remain at a variable interest rate. The bonds are subject to conversion to a term interest rate and mandatory tender upon such conversion. The Series 2003A bonds are subject to mandatory

SRI International and Subsidiaries

Notes to Consolidated Financial Statements

December 25, 2010 and December 26, 2009

redemption by lot, from sinking fund payments on September 1, annually through 2028, and through 2031, respectively.

SRI has no obligation to make any direct payments with respect to bonds tendered for purchase. The purchase price of bonds tendered is payable only from the proceeds of the remarketing of such bonds and from amounts from a bank letter of credit, currently with Wells Fargo bank. The letter of credit was issued to ensure payment of the bonds to the holders and to enhance the credit rating and marketability of the bonds. Under the bank letter of credit agreement SRI would be obligated to reimburse Wells Fargo for any bonds tendered to Wells Fargo. The bank letter of credit expires on September 1, 2012. SRI is required to present its bond obligation as a current liability because the letter of credit contains a subjective acceleration clause.

Under the terms of the various agreements entered into in connection with the issuance of the bonds, SRI must comply with certain covenants including maintenance of corporate existence; maintenance of records and filing of financial statements; payment of taxes, utilities and other charges; maintenance of tax-exempt status of interest on the bonds. In addition, Wells Fargo can accelerate the debt in the event of any breach of material terms, covenants or agreements, any impairment of the collateral or proceeds or any material adverse change that Wells Fargo believes impairs or is substantially likely to impair repayment or performance by SRI. SRI received a waiver from the lender due to a covenant violation indicating they will not request acceleration due to this covenant violation.

Series 2010 Bonds

In March 2010, the California Infrastructure and Economic Development Bank issued \$15 million Tax-Exempt Variable Rate Demand Revenue Bonds on behalf of SRI. The proceeds from this bond issuance were for the financing or refinancing of the acquisition, construction, installation, improvement, renovation, remodeling, replacement, furnishing and equipping of certain research facilities owned and operated by SRI and located at SRI's main campus at Menlo Park.

The 2010 Bonds are subject to optional and mandatory sinking fund redemption and optional and mandatory tender for purchase at any time they remain at a variable interest rate. The bonds are subject to conversion to a term interest rate and mandatory tender upon such conversion. The bonds are subject to mandatory redemption by lot, from sinking fund payments on September 1, 2011 through 2031.

SRI has no obligation to make any direct payments with respect to bonds tendered for purchase. The purchase price of bonds tendered is payable only the proceeds of the remarketing of such bonds and from amounts from a bank letter of credit, currently with Wells Fargo bank. The letter of credit was issued to ensure payment of the bonds to the holders and to enhance the credit rating and marketability of the bonds. However, under the bank letter of credit agreement SRI would be obligated to reimburse Wells Fargo for any bonds tendered to Wells Fargo. The bank letter of credit expires on September 1, 2012.

SRI is required to present the bond obligation as a current liability due to the debt being collateralized by line of credit that contains a subjective acceleration clause. Under the terms of the various agreements entered into in connection with the issuance of the bonds, SRI must comply with certain covenants including maintenance of corporate existence, maintenance of records and filing of financial statements, payment of taxes, utilities and other charges; maintenance of tax-exempt status of interest on the bonds. In addition, Wells Fargo can accelerate the debt in the event of any breach of material terms, covenants or agreements, any impairment of

SRI International and Subsidiaries
Notes to Consolidated Financial Statements
December 25, 2010 and December 26, 2009

the collateral or proceeds or any material adverse change that Wells Fargo believes impairs or it substantially likely to impair repayment or performance by SRI.

Line of Credit

As of December 25, 2010 and December 26, 2009, SRI has an available line of credit of \$12,300,000 and \$22,621,000, respectively, with Wells Fargo Bank. \$10,962,000 was outstanding as of December 25, 2010. Borrowings under the line are collateralized by real property. Interest rates on the line of credit as of December 25, 2010 and December 26, 2009 were LIBOR plus 1.5%. The line of credit expires on September 1, 2012.

SRI's line of credit contains restrictive covenants which require, among other items, the maintenance of defined levels of capital, current ratios, liabilities to total capital, net excess of revenues over expenses, and earnings. In addition, these covenants limit capital expenditures, loans, advances and investments.

Based on the borrowing rates currently available to SRI for loans with similar terms and average maturities, the carrying value of long term debt approximated fair value as of December 25, 2010 and December 26, 2009, respectively.

Maturities of debt as of December 25, 2010 were as follows:

2011	\$ 35,149,000
2012	206,000
2013	219,000
2014	107,000
2015	-
Thereafter	<u>2,494,000</u>
	<u>\$ 38,175,000</u>

7. Other Noncurrent Liabilities

Other noncurrent liabilities as of December 25, 2010 and December 26, 2009 consisted of the following:

	December 25, 2010	December 26, 2009
Insurance claim payable	\$ 900,000	\$ 5,084,000
Long term asset retirement obligation	6,284,000	5,924,000
Deferred tax liabilities	517,000	5,625,000
Unrecognized tax benefits	2,867,000	3,005,000
Long term lease liability	2,960,000	3,154,000
Client advances	4,480,000	7,835,000
Liability under deferred benefit plan	159,000	785,000
Other liabilities	-	75,000
	<u>\$ 18,167,000</u>	<u>\$ 31,487,000</u>

SRI International and Subsidiaries
Notes to Consolidated Financial Statements
December 25, 2010 and December 26, 2009

8. Leases

SRI is obligated under noncancelable capital and operating leases, primarily for office space and equipment that expire through 2020. SRI receives lease revenue primarily for office space under leases that expire in 2012. Future minimum lease payments and lease revenue under noncancelable capital and operating leases as of December 25, 2010 were as follows:

	Capital Lease Payments Payable	Operating Lease Payments Payable	Operating Lease Payments Receivable
2011	\$ 578,000	\$ 5,425,000	\$ 2,856,000
2012	578,000	5,059,000	2,299,000
2013	579,000	4,699,000	245,000
2014	590,000	4,367,000	71,000
2015	602,000	3,949,000	71,000
Thereafter	790,000	5,477,000	321,000
	<u>3,717,000</u>	<u>\$ 28,976,000</u>	<u>\$ 5,863,000</u>
Less: Amount representing interest	<u>631,000</u>		
Present value of minimum lease payments	3,086,000		
Less: Current portion	<u>404,000</u>		
Long term capital lease obligations	<u>\$ 2,682,000</u>		

Rental expense for all operating leases for the years ended December 25, 2010 and December 26, 2009 was approximately \$6,328,000 and \$4,917,000, respectively. Lease expense for significant leases is recorded on a straight-line basis in the case of pre-established increases in future lease payments.

Rental income for all operating leases for the years ended December 25, 2010 and December 26, 2009 was approximately \$3,445,000 and \$3,373,000, respectively.

SRI International and Subsidiaries
Notes to Consolidated Financial Statements
December 25, 2010 and December 26, 2009

9. Income Taxes

Income tax expense consisted of:

	December 25, 2010	December 26, 2009
Current		
U.S. federal	\$ (384,000)	\$ (33,000)
State	71,000	(38,000)
Foreign	(250,000)	(293,000)
	<u>(563,000)</u>	<u>(364,000)</u>
Deferred		
U.S. federal	(4,385,000)	(126,000)
State	(1,128,000)	(33,000)
	<u>(5,513,000)</u>	<u>(159,000)</u>
Total income tax (expense) benefit	<u>\$ (6,076,000)</u>	<u>\$ (523,000)</u>

The income tax expense attributable to pre-tax income differs from the amounts computed by applying the U.S. federal income tax rate of 34% to pretax income primarily as a result of the portions of SRI income exempt from income taxes and changes in the deferred tax valuation allowance. Substantially all income tax expense and deferred tax assets and liabilities are related to Sarnoff.

Deferred tax assets and deferred tax liabilities consisted of the following as of December 25, 2010 and December 26, 2009:

	December 25, 2010	December 26, 2009
Net operating loss carryforwards	\$ 35,507,000	\$ 37,845,000
Patents	3,483,000	3,743,000
Investments	116,000	947,000
Vacation provision	255,000	487,000
Accounts receivable	85,000	300,000
Inventory	275,000	223,000
Property, plant, and equipment	1,569,000	1,129,000
Other liabilities	1,505,000	1,009,000
Tax credits and carryforwards	340,000	1,060,000
Total gross deferred tax assets	<u>43,135,000</u>	<u>46,743,000</u>
Valuation allowance	(37,015,000)	(46,170,000)
Deferred tax assets	<u>6,120,000</u>	<u>573,000</u>
Less: Deferred tax liabilities		
Property and equipment	5,514,000	5,514,000
Other	606,000	572,000
Deferred tax liabilities	<u>6,120,000</u>	<u>6,086,000</u>
Net deferred tax liabilities	<u>\$ -</u>	<u>\$ (5,513,000)</u>

SRI International and Subsidiaries
Notes to Consolidated Financial Statements
December 25, 2010 and December 26, 2009

As of December 25, 2010 and December 26, 2009, Sarnoff had net operating loss carryforwards for federal and state income tax purposes of approximately \$40,720,000 and \$44,163,000 and \$42,884,000 and \$46,310,000, respectively, which are available to offset future taxable income, if any, and expire beginning in 2010. In addition, SRI and SRI Holdings had federal net operating loss carryforwards of approximately \$52,679,000, which are available to offset future taxable income, if any, and expire beginning in 2016. SRI, SRI Holdings, and Sarnoff have determined, based upon the weight of available evidence, that it is more likely than not that a significant portion of the net deferred tax assets will not be realized and, accordingly, have provided a valuation allowance. During the years ended December 25, 2010 and December 26, 2009 the valuation allowance decreased by \$6,814,000 and increased by \$3,402,000, respectively, on a consolidated basis.

U.S. income taxes have not been provided on undistributed earnings of non-U.S. subsidiaries of approximately \$1,183,000, which are deemed to be permanently invested.

SRI recognizes interest and penalties as incurred within income tax expense in the Consolidated Statements of Activities and Unrestricted Net Assets. During the years ended December 25, 2010 and December 26, 2009, SRI's liability for unrecognized tax benefits increased by \$131,000 and \$205,000, respectively, for interest costs.

10. Benefit Plans

Certain employees which meet length of service requirements are covered by defined contribution plans and by savings plans pursuant to Sections 401(k) and 403(b) of the Internal Revenue Code. Additionally, certain amounts are paid for foreign plans. The obligations under the plans are funded by SRI or its subsidiaries as necessary each year. Total retirement plan costs were \$14,701,000 and \$13,969,000 during the years ended December 25, 2010 and December 26, 2009, respectively.

SRI has an obligation under a predecessor company defined benefit plan (the "Plan") in the United Kingdom. The plan is closed to participant and no further benefits are accrued.

Expense under the Plan for the year ended December 25, 2010 and December 26, 2009 was as follows:

	December 25, 2010	December 26, 2009
Interest cost	\$ 158,000	\$ 341,000
Expected return on assets	<u>(88,000)</u>	<u>(73,000)</u>
	70,000	268,000
Net actuarial gain(loss)	<u>(269,000)</u>	<u>(2,606,000)</u>
Total pension expense (income)	<u>\$ (199,000)</u>	<u>\$ (2,338,000)</u>

SRI International and Subsidiaries
Notes to Consolidated Financial Statements
December 25, 2010 and December 26, 2009

Reconciliation at amounts recognized to SRI's balance sheet is as follows:

	December 25, 2010	December 26, 2009
Net balance sheet liability at beginning of year	\$ (1,211,000)	\$ (3,792,000)
Net periodic income	199,000	2,338,000
Employer contributions	407,000	500,000
Currency effects	40,000	(257,000)
Net balance sheet liability at end of year	<u>\$ (565,000)</u>	<u>\$ (1,211,000)</u>

The funded status of the Plan is as follows at December 25, 2010 and December 26, 2009:

	December 25, 2010	December 26, 2009
Accumulated and projected benefit obligation	\$ (2,761,000)	\$ (3,137,000)
Plan assets at fair value	<u>2,196,000</u>	<u>1,926,000</u>
Funded status	<u>\$ (565,000)</u>	<u>\$ (1,211,000)</u>

The change in the projected benefit obligation and fair value of plan assets was as follows for the years ended December 25, 2010 and December 26, 2009:

	December 25, 2010	December 26, 2009
Benefit obligation at beginning of year	\$ (3,137,000)	\$ (5,224,000)
Interest cost	(158,000)	(341,000)
Actuarial gain	145,000	2,526,000
Benefit payments	285,000	288,000
Currency effects	104,000	(386,000)
Benefit obligation at end of year	<u>\$ (2,761,000)</u>	<u>\$ (3,137,000)</u>

The change in plan assets was as follows for the years ended December 25, 2010 and December 26, 2009:

	December 25, 2010	December 26, 2009
Fair value of plan assets at beginning of year	\$ 1,926,000	\$ 1,432,000
Employer contributions	407,000	500,000
Benefit payments	(285,000)	(288,000)
Return on assets	212,000	153,000
Currency effects	(64,000)	129,000
Fair value of plan assets at end of year	<u>\$ 2,196,000</u>	<u>\$ 1,926,000</u>

SRI International and Subsidiaries
Notes to Consolidated Financial Statements
December 25, 2010 and December 26, 2009

The weighted average assumptions used to determine benefit obligations at December 25, 2010 were as follows:

	December 25, 2010	December 26, 2009
Discount rate	5.50 %	5.50 %
Pension increases	3.25 %	3.52 %

The weighted average assumptions used to determine net periodic benefit cost for the years ended December 25, 2010 and December 26, 2009 were as follows:

	December 25, 2010	December 26, 2009
Discount rate	5.50 %	6.25 %
Expected return on assets	4.50 %	4.50 %
Pension increases	3.25 %	3.00 %

Plan assets consist of equity and debt securities. The actual and target allocations were as follows as of December 25, 2010 and December 26, 2009:

	December 25, 2010		December 26, 2009	
	Actual %	Target %	Actual %	Target %
Equity	31.0	30.0	38.0	35.0
Debt	68.0	70.0	57.0	65.0
Other	1.0	-	5.0	-
	<u>100.0</u>	<u>100.0</u>	<u>100.0</u>	<u>100.0</u>

Expected benefit payments as of December 25, 2010 and December 26, 2009 are as follows:

	December 25, 2010	December 26, 2009
Year ending December,		
2011	\$ 175,000	\$ 342,000
2012	179,000	180,000
2013	184,000	185,000
2014	684,000	190,000
2015	196,000	717,000
2016 – 2020	1,903,000	1,952,000

The Plan's investment strategy involves investing in a mix of UK and overseas equity and debt securities to fully fund plan commitments over the next ten years. The mix will be adjusted each year to increase the percentage of debt securities and thereby reduce risk. Expected returns are derived based upon the existing allocation and historical results of the Plan assets.

SRI International and Subsidiaries

Notes to Consolidated Financial Statements

December 25, 2010 and December 26, 2009

11. Commitments and Contingencies

SRI has outstanding standby letters of credit as performance bonds in the amount of \$37,616 and \$23,770,000 as of December 25, 2010 and December 26, 2009, respectively.

Sarnoff has outstanding standby letters of credit as performance bonds in the amount of \$0 and \$2,664,000 as of December 25, 2010 and December 26, 2009, respectively.

Substantial amounts are received and expended by SRI under federal awards and are subject to audit by governmental agencies. The regulations governing federal awards are complex and can be subject to varying interpretations. Indirect costs are recorded based upon provisional rates throughout the year and are adjusted based upon actual audited costs and have been approved through 2005. Audits of incurred costs by governmental agencies have been completed through 2006, although final resolution has not been received from the applicable awarding agency. SRI recently became aware that, in certain instances, its system of internal control may not have fully complied with the requirements to monitor subrecipients. It is possible that certain subrecipient costs may not be allowable if the subrecipient did not comply with the applicable federal requirements.

SRI has made provisions for known and estimable exposures related to federal awards. However, given the inherent complexities in administering federal awards, it is possible that the aforementioned matters could result in disallowances in excess of the amounts provided, and that these differences could be material.

SRI is also involved in various claims and legal actions arising in the ordinary course of business. In the opinion of management, the ultimate disposition of these matters will not have a material effect on SRI's consolidated financial position.

SRI enters into guarantees and provides limited indemnifications in the ordinary course of business, such as to its Board in connection with their service on the Board. Based upon the nature of indemnifications provided, management has determined they have minimal value. SRI has not entered into significant guarantees and, therefore, no amounts have been provided in the accompanying financial statements.

Under the terms of an indemnification agreement dated March 31, 1987 between SRI and General Electric ("GE"), SRI and Sarnoff were indemnified for all claims, losses, damages or expenses which resulted from the operation of Sarnoff prior to March 31, 1987. One environmental matter exists that may require Sarnoff to pursue its indemnification with GE. In particular, Sarnoff is aware of a laboratory incinerator ash dump area that may require remediation at some future date. Estimates of the cost of remediation range from \$1,000,000 to \$8,000,000. As the pollution on this site occurred prior to the March 31, 1987 donation agreement, Sarnoff believes that GE, through the indemnification, or through other claims, will be held accountable for this remediation. Management of Sarnoff cannot estimate the potential outcome of other environmental matters on the property.

SRI International and Subsidiaries

Notes to Consolidated Financial Statements

December 25, 2010 and December 26, 2009

12. Related Party Transactions

Under a separation agreement with Stanford University ("Stanford"), SRI (and subsidiaries) is required to pay Stanford one half of 1% of its (and its subsidiaries') gross revenue from operations, less certain exclusions. SRI has a common board member with Stanford. Expense to Stanford under the separation agreement amounted to \$1,791,000 and \$1,647,000 as of December 25, 2010 and December 26, 2009, respectively, of which \$1,791,000 and \$1,647,000 were outstanding at year end, respectively. Receivables from Stanford amounted to \$87,000 and \$137,000 as of December 25, 2010 and December 26, 2009, respectively. In addition, for the year ended December 25, 2010, awards amounting to \$2,070,000 and \$968,000 were made to and received from Stanford. During the year ended December 29, 2007, SRI entered into a new lease agreement through 2012 with Stanford for the lease of research space, lease income for the year ended December 25, 2010 and December 26, 2009 amounted \$1,868,000 and \$1,868,000, respectively.

SRI also has a common board member with Nuance Communications and held shares of Nuance stock valued at \$11,030,000 and \$9,985,000 as of December 25, 2010 and December 26, 2009, respectively.

Sarnoff had contract revenue of approximately \$161,000 and \$239,000 from investee companies for the years ended December 25, 2010 and December 26, 2009, respectively, with related receivable balances of \$51,000 and \$16,000 as of December 25, 2010 and December 26, 2009, respectively. Sarnoff has a common board member with Agile TV (Promptu Systems), which leases space on the Menlo Park campus from SRI. SRI received rental and other service income from Agile TV totaling \$167,000 and \$158,000 for the years ended December 25, 2010 and December 26, 2009, respectively. SRI also has an investment in this entity of \$40,000 as of December 25, 2010 and December 26, 2009.

13. Subsequent Events

SRI has evaluated subsequent events through April 29, 2011, which is the date the consolidated financial statements were available to be issued.

SRI International
Schedule of Expenditures of State Financial Assistance
Year Ended December 25, 2010

Grantor/Program Title	CFSA Number	Award Amount	Contract Term	Expenditures
<u>State Financial Assistance:</u>				
Executive Office of the governor	31.054	\$20,000,000	11/22/2006 through 11/21/2026	<u>\$3,232,100</u>
Total State Awards				<u>\$3,232,100</u>

SRI International

Notes to Schedule of Expenditures of State Financial Assistance

Year Ended December 25, 2010

1. Summary of Significant Accounting Policies

Basis of Presentation

The accompanying Schedule of Expenditures of State Financial Assistance (the "Schedule") has been prepared in accordance with Chapter 691-5, *Rules of the Florida Department of Financial Services, Florida Administrative Code, Schedule of Expenditures of State Financial Assistance*. The purpose of the Schedule is to present a summary of those activities of SRI International ("SRI") for the year ended December 25, 2010 which have been financed by the State of Florida in accordance with the funding agreement entered into by and between SRI and the State of Florida, Executive Office of the Governor's Office of Tourism, Trade, and Economic Development ("OTTED") dated November 22, 2006 (the "Agreement").

This Schedule has been prepared using the cash basis of accounting. Because the Schedule presents only the state award activity of SRI, it is not intended to and does not present the financial position, changes in net assets or the cash flows of SRI.

Summary of State Award

In accordance with the Agreement, SRI has agreed to establish a state-of-the-art research institute and campus in the State of Florida focusing primarily on marine science and related fields. OTTED has agreed to fund, through the use of Incentive Funds (as defined in the Agreement), the development and costs associated with an approved organizational and business plan. The total amount of incentive funds that have been appropriated for the Agreement are \$20 million. The Agreement shall be in effect through November 21, 2026, unless terminated sooner in accordance with the Agreement. For purposes of the Schedule, state awards include state assistance received in accordance with the Agreement and are primarily related to a shortfall of costs incurred for (or cost of establishing) the Florida SRI office.

Corporate Allocations

Included in the accompanying Schedule are allocations of corporate costs that are based upon SRI's company-wide practice of allocating corporate costs to each of its operating organizations based upon the benefits derived. These allocations are associated with support functions such as Finance/Accounting, Human Resources, Public Relations, Information Technology, Security, Environmental Health and Safety, Legal, Intellectual Property, Contracts, and Procurement. These costs are allocated proportionally to each operating unit over a base representative of the services being provided.



**Report of Independent Certified Public Accountants on Internal Control over
Financial Reporting and on Compliance and Other Matters Based on an
Audit of Financial Statements Performed in Accordance with
*Government Auditing Standards***

To the Board of Directors
SRI International

We have audited the financial statements of SRI International and its subsidiaries ("SRI") as of and for the year ended December 25, 2010, and have issued our report thereon dated April 29, 2011. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered SRI's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of SRI's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the SRI's internal control over financial reporting.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis. A material weakness is a deficiency, or combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis.

Our consideration of internal control over financial reporting was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control over financial reporting that might be deficiencies, significant deficiencies, or material weaknesses. We did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses, as defined above.



Compliance and Other Matters

As part of obtaining reasonable assurance about whether SRI's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

This report is intended solely for the information and use of SRI's board of directors, audit committee, management, and federal and state awarding agencies and is not intended to be and should not be used by anyone other than these specified parties.

A handwritten signature in black ink that reads "Priscilla Hunt Cooper LLP".

April 29, 2011



Report of Independent Certified Public Accountants on Compliance with Requirements That Could Have a Direct and Material Effect on Each Major Program and on Internal Control Over Compliance in Accordance with Chapter 10.650, Rules of Auditor General

To the Board of Directors
SRI International

Compliance

We have audited the compliance of SRI International and its subsidiaries ("SRI") with the types of compliance requirements described in the Executive Office of the Governor's *State Projects Compliance Supplement* that are applicable to each of its major state programs for the year ended December 25, 2010. SRI's major state program is identified in the summary of auditor's results section of the accompanying schedule of findings and questioned costs. Compliance with the requirements of laws, regulations, contracts and grants applicable to its major state program is the responsibility of SRI's management. Our responsibility is to express an opinion on SRI's compliance based on our audit.

We conducted our audit of compliance in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and Executive Office of the Governor's *State Projects Compliance Supplement* and Chapter 10.650, *Rules of the Auditor General*. Those standards and Executive Office of the Governor's *State Projects Compliance Supplement* and Chapter 10.650, *Rules of the Auditor General* require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements referred to above that could have a direct and material effect on a major state program occurred. An audit includes examining, on a test basis, evidence about SRI's compliance with those requirements and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion. Our audit does not provide a legal determination on SRI's compliance with those requirements.

In our opinion, SRI complied, in all material respects, with the requirements referred to above that could have a direct and material effect on its major state program for the year ended December 25, 2010. However, the results of our auditing procedures disclosed instances of noncompliance with those requirements, which are required to be reported in accordance with Executive Office of the Governor's *State Projects Compliance Supplement* and Chapter 10.650, *Rules of the Auditor General* and which are described in the accompanying schedule of findings and questioned costs as item 2010-01.

Internal Control Over Compliance

Management of SRI is responsible for establishing and maintaining effective internal control over compliance with the requirements of laws, regulations, contracts, and grants applicable to state programs. In planning and performing our audit, we considered SRI's internal control over compliance with the requirements that could have a direct and material effect on a major state program in order to determine our auditing procedures for the purpose of expressing our opinion on compliance and to test and report on internal control over compliance in accordance with Executive Office of the Governor's



State Projects Compliance Supplement and Chapter 10.650, *Rules of the Auditor General*, but not for the purpose of expressing an opinion on the effectiveness of internal control over compliance.

Accordingly we do not express an opinion on the effectiveness of SRI's internal control over compliance.

A deficiency in internal control over compliance exists when the design or operation of a control over compliance does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct noncompliance with a type of compliance requirement of a state program on a timely basis. A material weakness in internal control over compliance is a deficiency, or combination of deficiencies, in internal control over compliance, such that there is a reasonable possibility that material noncompliance with a type of compliance requirement of a state program will not be prevented, or detected and corrected on a timely basis.

Our consideration of internal control over compliance was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control over compliance that might be deficiencies, significant deficiencies, or material weaknesses. We did not identify any deficiencies in internal control over compliance that we consider to be material weaknesses, as defined above

SRI's responses to the findings identified in our audit are described in the accompanying schedule of findings and questioned costs. We did not audit SRI's responses and, accordingly, we express no opinion on the responses.

This report is intended solely for the information and use of SRI's board of directors, audit committee, management and state awarding agencies and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties.

A handwritten signature in black ink that reads "Priscilla A. Cooper CPA".

September 26, 2011

SRI International
Schedule of Findings and Questioned Costs
Year Ended December 25, 2010

Section I – Summary of Auditor’s Results

Financial Statements

Type of auditor's report issued Unqualified

Internal control over financial reporting:

 Material weakness(es) identified?..... No

 Significant deficiency(ies) identified that are not considered to
be material weakness(es)? None Reported

Non-compliance which is material to the financial statements? No

State Awards

Type of auditor's report issued on compliance for major state projects..... Unqualified

Internal control over major programs:

 Material weakness(es) identified?..... No

 Significant deficiency(ies) identified that are not considered to
be material weakness(es)? None Reported

Audit findings required to be reported in accordance with Rule 10.654(1)(h)4 of Rules of the Auditor
General?..... Yes

Major State projects:

<u>CSFA Number</u>	<u>State Program or Cluster</u>
31.054	Innovation Incentive Program

Dollar threshold used to distinguish between Type A and Type B programs \$300,000

Auditee qualifies as a low-risk auditee not applicable for state programs

Section II - Financial Statement Findings

No matters reported.

SRI International

Schedule of Findings and Questioned Costs, Continued

Year Ended December 25, 2010

Section III – State Financial Assistance Findings and Questioned Costs

Finding 2010-01: Late Reporting

State Program

- Fiscal Year 2010 audited financial statements filed 16 days late
- Quarterly financial report filed 9 days late

Condition

In testing the compliance reporting requirements, there were two instances out of seven financial and non-financial reports sampled where required reports were submitted late as determined by the Funding agreement. The number of days late for each is provided above.

Citation

Paragraphs 8.2, 8.3 and 8.4 of the Funding Agreement between SRI International and the Office of Tourism, Trade and Economic Development

Questioned Costs

None

Criteria

Recipients report on the final performance and special aspects of projects. The reporting and filing requirements are prescribed by the awarding agencies guidelines. The reports are required to be submitted to the within the prescribed deadlines.

Cause

One of the reports was not received prior to the due date and thus could not be submitted on time. The other report was filed late due to an oversight.

Effect

Reports were not submitted within the timeframe, thereby hindering the review process.

Recommendation

We recommend that management continue to focus on its process for completing reports on time in order to further improve the timeliness of report submission. In addition, when management foresees reporting deadlines will likely not be met, approval from sponsors for late filing needs to be obtained prior to the reporting deadline. Also, we recommend that written documentation of sponsoring agency's approval is obtained and referenced when the reports are submitted.

Management's Views and Corrective Action Plan

Management's response is reported in "Management's Response and Corrective Action Plan" and is considered part of this report.

SRI International
Summary Schedule of Prior Year Audit Findings
Year Ended December 26, 2009

#	Description	Status
09-01	Late Reporting - PwC noted 19 out of 65 reports were filed late.	Corrective action plan from prior year was implemented for the federal awards.



Section III – State Financial Assistance Findings and Questioned Costs

Finding 2010-01: Late Reporting

Summary Finding:

State Program

- *Fiscal Year 2010 audited financial statements filed 16 days late*
- *Quarterly financial report filed 9 days late*

Condition

In testing the compliance reporting requirements, there were two instances out of seven financial and non-financial reports sampled where required reports were submitted late as determined by the Funding agreement.

SRI's Response:

The SRI Contracts Department continues to refine our process to work closer with Project Leaders to ensure that deliverables are submitted in a timely manner. The number of late deliverables in 2010 represents a significant decrease from 2009 (SRI has increased our on-time delivery by 15% from 2009 to 2010). In addition, we have significantly reduced the number of days that the deliverables are submitted late, and increased the number of notifications submitted to client(s) to extend the deliverable deadline. However, SRI understands that any amount of late deliverables constitutes a finding and as such is reflected in PWC's audit report.

Corrective Action Plan:

As stated above, The SRI Contracts Department continues to refine our process to work closer with Project Leaders to ensure that deliverables are submitted in a timely manner. All deliverables are currently entered into a web-based Deliverables Dashboard system (SRI's "CR&D Dashboard"). After entry into the CR&D Dashboard, deliverables are constantly monitored by all staff involved in the administration of research projects. In addition, the following steps are being taken to ensure continuous improvement in submitting deliverables in a timely manner:

1. The SRI Division Vice Presidents are currently taking an active role in assisting with the tracking and monitoring of deliverables to avoid delinquency. The Vice Presidents routinely review the deliverables status at their Divisional weekly/bi-weekly status meetings. In addition, deliverables are reviewed bi-monthly at SRI's Senior Staff Meeting, which is attended by all SRI Vice Presidents as well as SRI's Chief Executive Officer.
2. We currently generate deliverable reminders which are provided to Project Administrators, Contract Administrators, Business Managers and Project Leaders on the first day of each month. These reminders list deliverables due in the next 30 days as well as deliverables which have become delinquent in the last 30 days.
3. Contracts Administrators, Project Administrators, and Vice Presidents monitor the deliverable status on the CR&D Dashboard on a weekly basis.


4. In order to facilitate greater monitoring, the CR&D Dashboard will be modified to allow Vice Presidents the ability to monitor the number of reports submitted late for the current period as well as year to date deliverable(s) status, i.e., number and percentage of on time deliverables. In addition, to increase our rate of on-time submission of deliverables, we have added two additional reports as follows:
- a. Each Monday, the system will auto generate a list (to Project Administrators, Contract Administrators, Business Manager and Project Leaders) of all deliverables due in the next 5 days.
 - b. On the 10th of each month a report of all Late Deliverables will be sent to Project Administrators, Contract Administrators, Project Leaders/Co-Leaders/Supervisors and Vice Presidents.

Corrective Action Plan Prepared By:
(For Finding 2010-01)


Lillie Ryans-Culclager
Director of Contracts

9/26/11
Date

Corrective Action Plan Approved By:


Richard H. Abramson
Vice President
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9/26/11
Date