

SRI International

**Reports on Financial Statements and
Schedule of Expenditures of State Financial
Assistance in Accordance with Chapter 10.650 Rules
of the Auditor General
December 31, 2011**

SRI International
Reports on State Financial Assistance in Accordance with
Chapter 10.650 Rules of the Auditor General
Year Ended December 31, 2011

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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 31, 2011 and December 25, 2010, 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 25, 2012 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 31, 2011. 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 consolidated financial statements as a whole. The accompanying Schedule of Expenditures of State Financial Assistance, for the year ended December 31, 2011, is presented for purposes of additional analysis as required by Chapter 10.650, *Rules of Auditor General*, Florida Single Audit Act, and is not a required part of the basic



consolidated 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 is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the financial statements. The information has been subjected to the auditing procedures applied in the audit of the financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the financial statements or to the financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the information is fairly stated in all material respects, on the basis of accounting described in Note 1, in relation to the financial statements as a whole.

Priscilla A. Hunt-Carpenter LLP

April 25, 2012

SRI International and Subsidiaries
Consolidated Balance Sheets
December 31, 2011 and December 25, 2010

	December 31, 2011	December 25, 2010
Assets		
Current assets		
Cash and cash equivalents	\$ 83,804,000	\$ 91,754,000
Restricted cash and cash equivalents	1,352,000	9,039,000
Investments	12,712,000	11,056,000
Receivables (including contractual retentions and deferred billings: \$72,958,000 in 2011 and \$63,274,000 in 2010; less allowance for uncollectible accounts: \$2,828,000 in 2011 and \$3,189,000 in 2010)	116,274,000	97,779,000
Inventory	3,868,000	2,005,000
Prepaid expenses and other assets	5,940,000	7,518,000
Total current assets	223,950,000	219,151,000
Property and equipment, net	110,073,000	109,729,000
Other noncurrent assets, net	10,335,000	11,277,000
Total assets	\$ 344,358,000	\$ 340,157,000
Liabilities and Unrestricted Net Assets		
Current liabilities		
Accounts payable and accrued expenses	\$ 77,522,000	\$ 80,016,000
Line of credit	-	10,962,000
Client advances and credits	27,904,000	14,544,000
Current portion of capital lease obligations	394,000	404,000
Current installments of long-term debt	33,825,000	35,149,000
Total current liabilities	139,645,000	141,075,000
Long-term portion of capital lease obligations	2,253,000	2,682,000
Long-term debt, excluding current installments	2,957,000	3,026,000
Other noncurrent liabilities	9,468,000	18,167,000
Total liabilities	154,323,000	164,950,000
Commitments and contingencies (see Note 11)		
Unrestricted net assets	190,035,000	175,207,000
Total liabilities and unrestricted net assets	\$ 344,358,000	\$ 340,157,000

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

SRI International and Subsidiaries
Consolidated Statements of Activities and Unrestricted Net Assets
Years Ended December 31, 2011 and December 25, 2010

	December 31, 2011	December 25, 2010
Project revenue	\$ 577,502,000	\$ 494,982,000
Royalty revenue	7,728,000	7,771,000
Net revenue	<u>585,230,000</u>	<u>502,753,000</u>
Direct project costs	<u>(361,898,000)</u>	<u>(291,606,000)</u>
Excess of net revenue over direct project costs	<u>223,332,000</u>	<u>211,147,000</u>
Indirect expenses		
Salaries, wages, and benefits	130,942,000	130,382,000
Property and equipment	40,939,000	41,065,000
Materials, services, travel, and other	33,994,000	34,789,000
Internal research programs	<u>13,181,000</u>	<u>7,958,000</u>
Total indirect expenses	<u>219,056,000</u>	<u>214,194,000</u>
Other income (expense)		
Interest income	291,000	398,000
Interest expense	(404,000)	(805,000)
Stanford University separation expense	(2,092,000)	(1,791,000)
Realized gains on investments	1,983,000	29,865,000
Restructuring costs	-	(4,768,000)
Other, net	<u>6,163,000</u>	<u>3,714,000</u>
Total other income (expense), net	<u>5,941,000</u>	<u>26,613,000</u>
	10,217,000	23,566,000
Equity in earnings from affiliates	-	(678,000)
Unrealized gains on investments	<u>1,680,000</u>	<u>465,000</u>
Income before income taxes	11,897,000	23,353,000
Income tax benefit	<u>2,931,000</u>	<u>6,076,000</u>
Change in unrestricted net assets	14,828,000	29,429,000
Unrestricted net assets - beginning of year	<u>175,207,000</u>	<u>145,778,000</u>
Unrestricted net assets - end of year	<u>\$ 190,035,000</u>	<u>\$ 175,207,000</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 31, 2011 and December 25, 2010

	December 31, 2011	December 25, 2010
Cash flows from operating activities		
Change in unrestricted net assets	\$ 14,828,000	\$ 29,429,000
Adjustments to reconcile change in unrestricted net assets to net cash provided by operating activities		
Depreciation and amortization	18,415,000	16,179,000
Provision for doubtful accounts	(361,000)	(969,000)
(Gain) loss on investments	(3,663,000)	(30,464,000)
Equity in earnings from affiliates	-	678,000
Loss on sale of property and equipment	23,000	(19,000)
Deferred tax expense	-	(5,513,000)
Changes in operating assets and liabilities		
Restricted cash and cash equivalents	7,687,000	(8,041,000)
Receivables, net	(16,965,000)	1,660,000
Inventory	(1,863,000)	(261,000)
Prepaid expenses and other assets	1,061,000	(1,717,000)
Other assets, net	194,000	782,000
Accounts payable and accrued expenses	1,129,000	10,777,000
Client advances and credits	13,360,000	(2,427,000)
Other noncurrent liabilities	(7,198,000)	(4,216,000)
Net cash provided by operating activities	<u>26,647,000</u>	<u>5,878,000</u>
Cash flows from investing activities		
Purchase of investments	(100,000)	(225,000)
Sale and maturity of investments	2,007,000	31,906,000
Capital expenditures	(18,784,000)	(24,032,000)
Proceeds from sale of property and equipment	2,000	210,000
Net cash (used in) provided by investing activities	<u>(16,875,000)</u>	<u>7,859,000</u>
Cash flows from financing activities		
Proceeds from issuance of long-term debt	55,000	15,753,000
Principal payments of long-term debt	(1,584,000)	(3,950,000)
Payments under capital lease	(439,000)	(705,000)
Change in bank overdraft	(4,792,000)	(365,000)
(Payments) proceeds from line of credit, net	(10,962,000)	10,962,000
Net cash (used in) provided by financing activities	<u>(17,722,000)</u>	<u>21,695,000</u>
Net (decrease) increase in cash and cash equivalents	(7,950,000)	35,432,000
Cash and cash equivalents		
Beginning of year	91,754,000	56,322,000
End of year	<u>\$ 83,804,000</u>	<u>\$ 91,754,000</u>
Supplemental disclosures of cash flow information		
Cash paid during the year for		
Interest, net of amount capitalized	\$ 88,000	\$ 269,000
Noncash transactions		
Insurance claims paid to claimants directly by insurance company	331,000	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 31, 2011 and December 25, 2010

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 uses a fiscal year that ends on the last Saturday in December. The fiscal years ended December 31, 2011 and December 25, 2010 included 53 and 52 weeks of operations, respectively. SRI's subsidiary, Averatek Corporation ("Averatek") and former subsidiaries, Sarnoff Corporation ("Sarnoff") and SRI Holdings 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 subsidiary, Averatek in which SRI has a majority interest. Effective January 1, 2011, upon dissolution of Sarnoff and SRI Holdings, the assets, liabilities and operations of these subsidiaries were transferred to SRI. 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 consists principally of services performed in accordance with federal awards and is recognized based upon applicable input or output measures such as costs incurred under cost reimbursable or fixed price contract arrangements and product sales. 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 31, 2011 and December 25, 2010

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 consist solely of equity securities with readily determinable fair values and are reported at fair value based upon quoted market prices.

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 31, 2011 and December 25, 2010

Credit Risk

Substantially all the 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 product in inventory for sale to customers, as well as supplies used in research activities and project related equipment. Product inventory consist of raw material parts, work-in-process and finished goods. Inventories are valued at the lower of cost or market value, 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. Assets acquired under both federal and nonfederal awards in which title does not ultimately transfer to SRI is not recorded as property and equipment.

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 the shorter of the term of the respective lease 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 asset. The amortization of assets recorded under capital leases is included in depreciation and amortization expense in the accompanying consolidated statements of activities and unrestricted net assets. 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.

During 2011 and 2010, SRI capitalized approximately \$14,000 and \$20,000 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 their estimated lives. In addition, SRI evaluates goodwill and intangibles for impairment annually or whenever events or changes in circumstances indicate that goodwill or intangibles might be impaired.

SRI International and Subsidiaries

Notes to Consolidated Financial Statements

December 31, 2011 and December 25, 2010

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 assets exceeds the fair value of the assets. There were no impairment losses for the years ended December 31, 2011 and December 25, 2010.

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. Accretion expense for 2011 and 2010 was \$340,000 and \$296,000, respectively. 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 \$6,560,000 and \$6,284,000 are included in other noncurrent liabilities in the consolidated balance sheets at December 31, 2011 and December 25, 2010, 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. Averatek is a taxable corporation. 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

An amount in the consolidating balance sheet (related to certain receivables) in the 2010 financial statements was reclassified to conform to the 2011 financial statement presentation. This reclassification 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 31, 2011 and December 25, 2010

2. Investments

Investments as of December 31, 2011 and December 25, 2010 consist of the following marketable securities:

	December 31, 2011	December 25, 2010
Nuance Communications common stock	\$ 12,666,000	\$ 11,030,000
Intuitive Surgical common stock	46,000	26,000
	<u>\$ 12,712,000</u>	<u>\$ 11,056,000</u>

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

	December 31, 2011	December 25, 2010
Unrealized		
Nuance Communications common stock	\$ 1,660,000	\$ 1,051,000
Intuitive Surgical common stock	20,000	(586,000)
	<u>1,680,000</u>	<u>465,000</u>
Realized		
Siri common and preferred stock	-	28,832,000
Nuance Communications common stock	1,983,000	641,000
Intuitive Surgical common stock	-	422,000
Other equity securities	-	(30,000)
	<u>1,983,000</u>	<u>29,865,000</u>
	<u>\$ 3,663,000</u>	<u>\$ 30,330,000</u>

All investments held as of December 31, 2011 and December 25, 2010, respectively, are considered Level 1 investments with quoted prices in active markets.

3. Property and Equipment

Property and equipment as of December 31, 2011 and December 25, 2010 consist of the following:

	December 31, 2011	December 25, 2010
Land and improvements	\$ 21,461,000	\$ 18,439,000
Buildings	189,844,000	162,434,000
Equipment	75,699,000	138,979,000
Leasehold improvements	6,251,000	6,067,000
Construction-in-progress	3,511,000	7,994,000
	<u>296,766,000</u>	<u>333,913,000</u>
Less: Accumulated depreciation and amortization	<u>(186,693,000)</u>	<u>(224,184,000)</u>
	<u>\$ 110,073,000</u>	<u>\$ 109,729,000</u>

SRI International and Subsidiaries
Notes to Consolidated Financial Statements
December 31, 2011 and December 25, 2010

Depreciation and amortization expense for the years ended December 31, 2011 and December 25, 2010 was \$18,415,000 and \$16,179,000, respectively. Depreciation expense for the years ended December 31, 2011 and December 25, 2010 was \$17,419,000 and \$15,105,000, respectively.

As of December 31, 2011, SRI held \$90,364,000 of fully depreciated assets.

4. Other Noncurrent Assets

Other noncurrent assets as of December 31, 2011 and December 25, 2010 consist of the following:

	December 31, 2011	December 25, 2010
Contractual retention and fee withhold receivable	\$ 8,500,000	\$ 8,412,000
Goodwill	129,000	221,000
Other intangible assets, net	921,000	921,000
Investments in affiliates, net	372,000	272,000
Insurance receivable	-	900,000
Other	413,000	551,000
	<u>\$ 10,335,000</u>	<u>\$ 11,277,000</u>

In April 2010, SRI finalized the sale of its equity investments 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 31, 2011 and December 25, 2010 consist of the following:

	December 31, 2011	December 25, 2010
Accounts payable	\$ 36,058,000	\$ 35,366,000
Accrued payroll, vacation and other employee related accruals	34,673,000	31,870,000
Bank overdraft	-	4,792,000
Stanford separation expense (Note 12)	2,092,000	1,791,000
Accrued insurance	3,006,000	2,881,000
Other	1,693,000	3,316,000
	<u>\$ 77,522,000</u>	<u>\$ 80,016,000</u>

SRI International and Subsidiaries
Notes to Consolidated Financial Statements
December 31, 2011 and December 25, 2010

6. Long-Term Debt

Long-term debt as of December 31, 2011 and December 25, 2010 consists of the following:

	December 31, 2011	December 25, 2010
California Infrastructure and Development Bank Revenue Bond Series 2003A Tax-exempt Variable Rate Demand Revenue Bonds ("Series 2003A Bonds"), payable through 2028 interest at 0.08% at December 31, 2011 and 0.33% at December 25, 2010	\$ 19,559,000	\$ 20,268,000
California Infrastructure and Development Bank Revenue Bond Series 2010 Tax-exempt Variable Rate Demand Revenue Bonds ("Series 2010 Bonds"); interest at 0.08% at December 31, 2011 and 0.33% at December 25, 2010	14,075,000	14,486,000
Note payable from Sarnoff to bank, collateralized by equipment, interest at 7.75% on \$138,000 and interest at 8.5% on \$63,000, matured in August 2011.	-	201,000
Notes payable from Averatek to its minority investor, CSL, interest at 4.73% on \$674,000, 3.2% on \$672,000, 2.87% on \$297,000, 2.66% on \$72,000, 2.64% on \$48,000, 2.82% on \$206,000, 2.7% on \$266,000, 1.59% on \$102,000, 1.53% on 239,000 and 2.0% on \$55,000.	2,631,000	2,494,000
Notes payable from Averatek to bank, collateralized by equipment, interest at 5.99% payable in monthly installments through 2014	517,000	726,000
Total principal amounts	<u>36,782,000</u>	<u>38,175,000</u>
Less: Current installments	<u>33,825,000</u>	<u>35,149,000</u>
Long-term debt, excluding current installments	<u>\$ 2,957,000</u>	<u>\$ 3,026,000</u>

Series 2003A Bonds

In September 2003, the California Infrastructure and Development 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 in Menlo Park.

Series 2010 Bonds

In March 2010, the California Infrastructure and Economic Development Bank issued \$15 million Tax-Exempt Variable Rate Demand Revenue Bonds (the "Series 2010") 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 in Menlo Park.

SRI International and Subsidiaries

Notes to Consolidated Financial Statements

December 31, 2011 and December 25, 2010

The Series 2003A bonds and Series 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 Series 2003A bonds are subject to mandatory redemption by lot, from sinking fund payments on September 1, annually through 2028. The Series 2010 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 from the proceeds of the remarketing of such bonds and from amounts from bank letters of credit, currently with Wells Fargo bank. The letters of credit were issued to ensure payment of the bonds to the holders and to enhance the credit rating and marketability of the bonds. Under the bank letters of credit agreements SRI would be obligated to reimburse Wells Fargo for any bonds tendered to Wells Fargo. The available bank letter of credit is \$20,288,000 on the Series 2003A bonds and \$14,776,000 on the Series 2010 bonds with no amounts drawn against either letter of credit at December 31, 2011 and 2010. The letters of credit expire on September 1, 2012. SRI is required to present its bond obligations as a current liability because the letters 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. At December 31, 2011, SRI is in compliance with its covenants.

Line of Credit

As of December 31, 2011 and December 25, 2010, SRI has an available line of credit of \$20,217,000 and \$12,300,000, respectively, with Wells Fargo Bank. There was no amount outstanding as of December 31, 2011 and \$10,962,000 outstanding as of December 25, 2010. Borrowings under the line are collateralized by real property. The interest rate on the line of credit as of December 31, 2011 and December 25, 2010 was 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, liabilities to total capital, net excess of revenues over expenses, and earnings. In addition, these covenants limit capital expenditures, loans, advances and investments. At December 31, 2011, SRI is in compliance with its covenants.

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 31, 2011 and December 25, 2010, respectively.

SRI International and Subsidiaries
Notes to Consolidated Financial Statements
December 31, 2011 and December 25, 2010

Maturities of debt as of December 31, 2011 were as follows:

2012	\$ 33,825,000
2013	219,000
2014	107,000
2015	-
2016	-
Thereafter	<u>2,631,000</u>
	<u>\$ 36,782,000</u>

7. Other Noncurrent Liabilities

Other noncurrent liabilities as of December 31, 2011 and December 25, 2010 consist of the following:

	December 31, 2011	December 25, 2010
Insurance claim payable	\$ -	\$ 900,000
Long term asset retirement obligation	6,560,000	6,284,000
Unrecognized tax benefits	-	2,867,000
Long term lease obligation	2,690,000	2,960,000
Client advances	218,000	4,480,000
Liability under deferred benefit plan	-	159,000
Other	-	517,000
	<u>\$ 9,468,000</u>	<u>\$ 18,167,000</u>

SRI International and Subsidiaries
Notes to Consolidated Financial Statements
December 31, 2011 and December 25, 2010

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 31, 2011 were as follows:

	Capital Lease Payments Payable	Operating Lease Payments Payable	Operating Lease Payments Receivable
2012	\$ 543,000	\$ 4,935,000	\$ 159,000
2013	579,000	4,654,000	158,000
2014	590,000	4,191,000	159,000
2015	602,000	3,571,000	158,000
2016	790,000	3,481,000	-
Thereafter	-	1,506,000	-
	<u>3,104,000</u>	<u>\$ 22,338,000</u>	<u>\$ 634,000</u>
Less: Amount representing interest	<u>457,000</u>		
Present value of minimum lease payments	<u>2,647,000</u>		
Less: Current portion	<u>394,000</u>		
Long term capital lease obligations	<u>\$ 2,253,000</u>		

Rental expense for all operating leases for the years ended December 31, 2011 and December 25, 2010 was approximately \$6,110,000 and \$6,328,000, 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 31, 2011 and December 25, 2010 was approximately \$3,775,000 and \$3,445,000, respectively.

SRI International and Subsidiaries
Notes to Consolidated Financial Statements
December 31, 2011 and December 25, 2010

9. Income Taxes

Income tax benefit (expense) consists of:

	December 31, 2011	December 25, 2010
Current		
U.S. federal	\$ 8,000	\$ 384,000
State	56,000	(72,000)
Foreign	2,867,000	250,000
	<u>2,931,000</u>	<u>562,000</u>
Deferred		
U.S. federal	-	4,385,000
State	-	1,129,000
	<u>-</u>	<u>5,514,000</u>
Total income tax benefit (expense)	<u>\$ 2,931,000</u>	<u>\$ 6,076,000</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.

SRI International and Subsidiaries
Notes to Consolidated Financial Statements
December 31, 2011 and December 25, 2010

Deferred tax assets and deferred tax liabilities consist of the following as of December 31, 2011 and December 25, 2010:

	December 31, 2011	December 25, 2010
Net operating loss carryforwards	\$ 33,254,000	\$ 35,507,000
Patents		3,483,000
Investments		116,000
Vacation provision		255,000
Accounts receivable		85,000
Inventory		275,000
Property, plant, and equipment	1,493,000	1,569,000
Other liabilities		1,505,000
Tax credits and carryforwards		340,000
Total gross deferred tax assets	34,747,000	43,135,000
Valuation allowance	(34,747,000)	(37,015,000)
Deferred tax assets	-	6,120,000
Less: Deferred tax liabilities		
Property and equipment		5,514,000
Other		606,000
Deferred tax liabilities	-	6,120,000
Net deferred tax liabilities	\$ -	\$ -

As of December 25, 2010, Sarnoff has net operating loss carryforwards for federal and state income tax purposes of approximately \$40,720,000 and \$42,884,000, respectively, which are available to offset future taxable income, if any, and expire beginning in 2011. The dissolution of Sarnoff and transfer of assets into SRI resulted in utilization of \$6,396,000 of net operating loss carryforwards and approximately \$34,375,000 from Sarnoff operations remain available to SRI. At December 31, 2011, SRI, including those transferred from Sarnoff, has net operating loss carryforwards for federal and state income tax purposes of approximately \$91,172,000 and \$23,395,000, respectively, which are available to offset future taxable income, if any, and expire beginning in 2013. SRI has 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 31, 2011 and December 25, 2010 the valuation allowance decreased by \$2,268,000 and \$9,155,000, respectively, on a consolidated basis.

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 31, 2011 and December 25, 2010, SRI's liability for unrecognized tax benefits decreased by \$269,000 and increased by \$131,000, respectively, for interest costs.

As of December 31, 2011, Sarnoff and SRI Holdings are no longer a part of SRI's consolidated group for income tax reporting purposes. Tax attributes associated with the Sarnoff merger are absorbed by the consolidated group.

SRI International and Subsidiaries
Notes to Consolidated Financial Statements
December 31, 2011 and December 25, 2010

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 as necessary each year. Total retirement plan costs were \$17,783,000 and \$14,701,000 during the years ended December 31, 2011 and December 25, 2010, respectively.

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

Expense under the Plan for the year ended December 31, 2011 and December 25, 2010 was as follows:

	December 31, 2011	December 25, 2010
Interest cost	\$ 152,000	\$ 158,000
Expected return on assets	(90,000)	(88,000)
	<u>62,000</u>	<u>70,000</u>
Net actuarial gain (loss)	154,000	(269,000)
Total pension expense (income)	<u>\$ 216,000</u>	<u>\$ (199,000)</u>

Reconciliation of amounts recognized on SRI's balance sheet is as follows:

	December 31, 2011	December 25, 2010
Net balance sheet liability at beginning of year	\$ (565,000)	\$ (1,211,000)
Net periodic income	(216,000)	199,000
Employer contributions	422,000	407,000
Currency effects	(9,000)	40,000
Net balance sheet liability at end of year	<u>\$ (368,000)</u>	<u>\$ (565,000)</u>

The funded status of the Plan is as follows at December 31, 2011 and December 25, 2010:

	December 31, 2011	December 25, 2010
Accumulated and projected benefit obligation	\$ (2,884,000)	\$ (2,761,000)
Plan assets at fair value	<u>2,516,000</u>	<u>2,196,000</u>
Funded status	<u>\$ (368,000)</u>	<u>\$ (565,000)</u>

SRI International and Subsidiaries
Notes to Consolidated Financial Statements
December 31, 2011 and December 25, 2010

The change in the projected benefit obligation and fair value of plan assets was as follows for the years ended December 31, 2011 and December 25, 2010:

	December 31, 2011	December 25, 2010
Benefit obligation at beginning of year	\$ (2,761,000)	\$ (3,137,000)
Interest cost	(152,000)	(158,000)
Actuarial gain	(149,000)	145,000
Benefit payments	176,000	285,000
Currency effects	2,000	104,000
Benefit obligation at end of year	<u>\$ (2,884,000)</u>	<u>\$ (2,761,000)</u>

The change in plan assets was as follows for the years ended December 31, 2011 and December 25, 2010:

	December 31, 2011	December 25, 2010
Fair value of plan assets at beginning of year	\$ 2,196,000	\$ 1,926,000
Employer contributions	422,000	407,000
Benefit payments	(176,000)	(285,000)
Return on assets	85,000	212,000
Currency effects	(11,000)	(64,000)
Fair value of plan assets at end of year	<u>\$ 2,516,000</u>	<u>\$ 2,196,000</u>

The weighted average assumptions used to determine benefit obligations at December 31, 2011 were as follows:

	December 31, 2011	December 25, 2010
Discount rate	4.75 %	5.50 %
Pension increases	3.00 %	3.25 %

The weighted average assumptions used to determine net periodic benefit cost for the years ended December 31, 2011 and December 25, 2010 were as follows:

	December 31, 2011	December 25, 2010
Discount rate	5.50 %	5.50 %
Expected return on assets	4.50 %	4.50 %
Pension increases	3.25 %	3.25 %

SRI International and Subsidiaries
Notes to Consolidated Financial Statements
December 31, 2011 and December 25, 2010

Plan assets consist of equity and debt securities and are considered Level 1 investments. The actual and target allocations were as follows as of December 31, 2011 and December 25, 2010:

	December 31, 2011		December 25, 2010	
	Actual %	Target %	Actual %	Target %
Equity	77.0 %	25.0 %	31.0 %	30.0 %
Debt	22.0	75.0	68.0	70.0
Other	1.0	0.0	1.0	0.0
	<u>100.0 %</u>	<u>100.0 %</u>	<u>100.0 %</u>	<u>100.0 %</u>

Expected benefit payments as of December 31, 2011 and December 25, 2010 are as follows:

	December 31, 2011	December 25, 2010
Year ending December,		
2012	\$ 176,000	\$ 175,000
2013	181,000	179,000
2014	655,000	184,000
2015	193,000	684,000
2016	519,000	196,000
2017–2021	1,709,000	1,903,000

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. Expected returns are derived based upon the existing allocation and historical results of the Plan assets.

11. Commitments and Contingencies

SRI has outstanding standby letters of credit as performance bonds in the amount of \$39,493,000 and \$37,616,000 as of December 31, 2011 and December 25, 2010, 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 International and Subsidiaries

Notes to Consolidated Financial Statements

December 31, 2011 and December 25, 2010

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. As SRI has not entered into significant guarantees, 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 SRI to pursue its indemnification with GE. In particular, SRI 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, SRI believes that GE, through the indemnification, or through other claims, will be held accountable for this remediation. Management of SRI cannot estimate the potential outcome of other environmental matters on the property.

12. Related Party Transactions

Under a separation agreement with Stanford University ("Stanford"), SRI is required to pay Stanford one half of 1% of its (and its subsidiaries') gross revenue from operations, less certain exclusions. Expense to Stanford under the separation agreement amounted to \$2,092,000 and \$1,791,000 for the years ended December 31, 2011 and December 25, 2010, respectively, of which \$2,092,000 and \$1,791,000 were outstanding at year end, respectively. Receivables from Stanford amounted to \$146,000 and \$87,000 as of December 31, 2011 and December 25, 2010, respectively. In addition, for the year ended December 31, 2011, awards amounting to \$2,387,000 and \$1,346,000 were made to and received from Stanford. Additionally, awards amounting to \$2,070,000 and \$968,000 were made to and received from Stanford for the year ended December 25, 2010. SRI has a lease arrangement through 2012 with Stanford for research space. Lease income for the year ended December 31, 2011 and December 25, 2010 amounted to \$1,868,000 and \$1,868,000, respectively. SRI has a common board member with Stanford.

SRI also has a common board member with Nuance Communications and held shares of Nuance stock valued at \$12,666,000 and \$11,030,000 as of December 31, 2011 and December 25, 2010, respectively.

SRI International and Subsidiaries

Notes to Consolidated Financial Statements

December 31, 2011 and December 25, 2010

SRI had contract revenue of approximately \$29,000 and \$161,000 from investee companies for the years ended December 31, 2011 and December 25, 2010, respectively, with a related receivable balance of \$51,000 as of December 25, 2010 and no receivable outstanding at December 31, 2011. Agile TV (Promptu Systems) leases space from the Menlo Park office of SRI. SRI received rental and other service income from Agile TV totaling \$170,000 and \$167,000 for the years ended December 31, 2011 and December 25, 2010, respectively. SRI also has an investment in this entity of \$40,000 as of December 31, 2011 and December 25, 2010. During 2010, Sarnoff had a common board member with Agile TV.

13. Subsequent Events

SRI has evaluated subsequent events through April 25, 2012, 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 31, 2011

Grantor/Program Title	CSFA 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>\$832,300</u>
Total State Awards				<u>\$832,300</u>

SRI International

Notes to Schedule of Expenditures of State Financial Assistance

Year Ended December 31, 2011

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 31, 2011 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 of establishing an office in the state. 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.

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 31, 2011, and have issued our report thereon dated April 25, 2012. 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 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 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, which appears to read "Priscilla Shurtz Cooper LLP".

April 25, 2012



**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 could have a direct and material effect on each of its major state programs for the year ended December 31, 2011. 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 of 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 31, 2011. 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 2011-01.



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 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. Hunt-Carpenter LLP".

June 25, 2012

SRI International
Schedule of Findings and Questioned Costs
Year Ended December 31, 2011

Part 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 of Cluster</u>
31.054	Innovation Incentive Program

Dollar threshold used to distinguish between Type A and Type B programs..... \$250,000

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

Part II - Financial Statement Findings

No matters reported.

SRI International

Schedule of Findings and Questioned Costs, Continued

Year Ended December 31, 2011

Part III – State Financial Assistance Findings and Questioned Costs

Finding 2011-01: Late Reporting

State Program

- Fiscal Year 2011 Audited Financial Statements filed 1 day late

Condition

In testing the compliance reporting requirements, there was one instance 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 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

The audited financial statements were received close to the reporting deadline, and SRI personnel were unable to submit timely.

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

SRI acknowledges the importance of monitoring project deliverables and will continue to stress compliance with client requirements and established policies and procedures. The SRI Project Team (Contracts, Subcontracts, Vice Presidents, Project Leaders, Business Managers and Project Administrators) will continue to utilize the deliverable tools, i.e., Deliverable Database, CR&D Dashboard and email notification system, to monitor the deliverables to ensure timely submission.

All technical reports must be provided by the PI, and the Business Unit prepares the financial reports. The Project Team currently follows up with the PI regarding the status of outstanding reports, and Contracts tracks the submission of technical, patent and financial reports in the Deliverables database. The Project Team will continue to follow up with the PI and seek assistance from the various department vice presidents as needed.

SRI International
Schedule of Findings and Questioned Costs, Continued
Year Ended December 31, 2011

Part III – State Financial Assistance Findings and Questioned Costs, Continued

Finding 2011-01: Late Reporting, Continued

Management's Views and Corrective Action Plan, Continued

In January 2012, Contracts and Internal Audit launched an additional partnership to assist in further reducing the number of late deliverables. Contracts and Internal Audit will continue to partner to understand and evaluate the root cause of late submissions and work with the project team to identify additional solutions for improvement in the process.

Our recent modifications to the deliverables collection process have proven successful (for Fiscal Year 2012, we have further improved and are now experiencing a less than 6% delinquency rate on filing deliverables). We will continue to implement the program in 2012. In addition, the Contracts staff will continue to work with the Project Team to seek client approval for deliverables that will not be submitted timely.

Client Contact:

Lillie Ryans-Culclager
Director, Contracts
SRI International
333 Ravenswood Avenue
Menlo Park, CA 94025
650-859-2651

SRI International
Summary Schedule of Prior Year Audit Findings
Year Ended December 25, 2010

#	Description	Status
2010-01	<p>Late Reporting</p> <ul style="list-style-type: none">• Fiscal Year 2010 audited financial statements filed 16 days late• Quarterly financial report filed 9 days late	<ul style="list-style-type: none">• SRI management implemented their plan to file the quarterly reports timely; however, the Financial Statements were submitted late.