SRC, Inc.

Report on Federal Awards in Accordance with
Title 2 U.S. *Code of Federal Regulations* Part 200,
Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards (Uniform Guidance)

September 30, 2018

SRC, Inc.

Report on Federal Awards in Accordance with the Uniform Guidance

Section

1

SRC, Inc. and Subsidiaries

Consolidated Financial Statements,
Independent Auditor's Report and Reports
Required by *Government Auditing Standards*
and the Uniform Guidance
Years Ended September 30, 2018 and 2017

SRC, Inc. and Subsidiaries

Consolidated Financial Statements, Independent Auditor's Report and Reports Required by *Government Auditing Standards* and the Uniform Guidance

Years Ended September 30, 2018 and 2017

SRC, Inc. and Subsidiaries

Contents

Tel: 703-893-0600
Fax: 703-893-2766
www.bdo.com

8401 Greensboro Drive
Suite 800
McLean, VA 22102

Independent Auditor's Report

Board of Directors
SRC, Inc. and Subsidiaries
Syracuse, New York

We have audited the accompanying consolidated financial statements of SRC, Inc. and Subsidiaries (SRC or the Company), which comprise the consolidated statement of financial position as of September 30, 2018, and the related consolidated statements of activities and change in unrestricted net assets and cash flows for the year then ended, and the related notes to the consolidated financial statements.

Management's Responsibility for the Consolidated Financial Statements

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of SRC, Inc. and Subsidiaries as of September 30, 2018 and the results of their operations and their cash flows for the year then ended in accordance with accounting principles generally accepted in the United States of America.

Other Matters

Supplemental information

Our audit was conducted for the purpose of forming an opinion on the consolidated financial statements as a whole. The accompanying schedule of expenditures of federal awards, as required by Title 2 U.S. Code of Federal Regulations (CFR) Part 200, *Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards*, is presented for purposes of additional analysis and is not a required part of the consolidated financial statements. 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 consolidated financial statements. The information has been subjected to the auditing procedures applied in the audit of the consolidated financial statements and certain additional procedures, including comparing and reconciling the information directly to the underlying accounting and other records used to prepare the consolidated financial statements or to the consolidated financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the schedule of expenditures of federal awards is fairly stated, in all material respects, in relation to the consolidated financial statements as a whole.

2017 Information

The 2017 consolidated financial statements of SRC, Inc. and Subsidiaries were audited by other auditors, whose report dated December 19, 2017 expressed an unmodified opinion on those consolidated statements.

Other Reporting Required by Government Auditing Standards

In accordance with *Government Auditing Standards*, we have also issued our report, dated December 19, 2018, on our consideration of the Company'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. The purpose of that report is solely 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 effectiveness of the Company's internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the Company's internal control over financial reporting and compliance.

BDO USA, LLP

McLean, Virginia
December 19, 2018, except for the schedule of expenditures
of federal awards, for which the date is June 26, 2019

Consolidated Financial Statements

SRC, Inc. and Subsidiaries

Consolidated Statements of Financial Position

September 30,		2018		2017
Assets				
Current assets				
Cash and cash equivalents	$	37,296,553	$	81,996,187
Investments		194,302,832		159,364,006
Accounts receivable, net of reserve for uncollectible accounts of $201,129 and $265,001 for 2018 and 2017, respectively		26,504,276		39,662,117
Accounts receivable - unbilled		26,122,694		22,835,657
Inventory, net		69,520,970		25,862,295
Deferred contract costs		10,625,153		8,053,404
Prepaid expenses and other assets		8,603,737		4,957,402
Total current assets		372,976,215		342,731,068
Property, buildings, and equipment, net		46,309,605		42,190,646
Investments		-		1,642,344
Other assets		7,688,086		9,633,236
Deferred income taxes		4,238,077		97,747
Total assets	$	431,211,983	$	396,295,041
Liabilities and Net Assets				
Current liabilities				
Lines-of-credit	$	12,007,705	$	1,448,000
Accounts payable		16,132,800		8,594,936
Accrued expenses		23,528,255		27,985,645
Billings in excess of revenue recognized		8,656,787		8,469,331
Long-term debt - current portion		1,132,500		1,082,500
Total current liabilities		61,458,047		47,580,412
Long-term debt, net of current portion and unamortized debt issuance costs (Note 5)		11,693,000		12,802,500
Other long-term liabilities		8,546,375		7,528,593
Total liabilities		81,697,422		67,911,505
Unrestricted net assets		349,514,561		328,383,536
Total liabilities and net assets	$	431,211,983	$	396,295,041

See accompanying notes to the consolidated financial statements.

SRC, Inc. and Subsidiaries

Consolidated Statements of Activities and Change in Unrestricted Net Assets

Years Ended September 30,	2018	2017
Operating activities		
Revenue	$ 319,979,841	$ 245,160,887
Costs of revenue		
Direct costs	196,805,672	152,836,548
Indirect expenses	69,776,644	59,940,887
Administrative expenses	48,684,854	42,796,321
Total operating expenses	315,267,170	255,573,756
Change in unrestricted net assets from operations	4,712,671	(10,412,869)
Non-operating activities		
Interest income and net gain on investments	14,209,806	20,279,863
Interest expense	(657,132)	(117,344)
Other income (expense), net	261,234	(376,518)
Foreign currency translation adjustment	(340,403)	67,367
Postretirement benefits adjustment	(506,452)	1,251,235
Total non-operating activities, net	12,967,053	21,104,603
Change in unrestricted net assets before benefit from income taxes	17,679,724	10,691,734
Benefit from income taxes	3,451,301	91,924
Change in unrestricted net assets after benefit from income taxes	21,131,025	10,783,658
Unrestricted net assets at the beginning of the year	328,383,536	317,599,878
Unrestricted net assets at the end of the year	$ 349,514,561	$ 328,383,536

See accompanying notes to the consolidated financial statements.

SRC, Inc. and Subsidiaries

Consolidated Statements of Cash Flows

Years Ended September 30,	2018	2017
Cash flows from operating activities:		
Change in unrestricted net assets	$ 21,131,025	$ 10,783,658
Adjustments to reconcile change in unrestricted net assets to net cash and cash equivalents used in operating activities:		
Depreciation and amortization	6,056,968	6,127,135
Change in inventory reserve	39,121	(528,000)
Realized and unrealized gain on investments	(8,341,000)	(14,670,000)
Change in deferred income taxes	(4,140,330)	(95,046)
Changes in operating assets and liabilities:		
Accounts receivable	13,157,841	(16,574,678)
Accounts receivable - unbilled	(3,287,037)	(7,201,720)
Inventory	(43,697,796)	(5,936,905)
Deferred contract costs	(2,571,749)	(4,764,575)
Prepaid expenses and other assets	(2,154,769)	(3,029,737)
Accounts payable, accrued expenses, and other liabilities	4,098,256	11,352,026
Billings in excess of revenue recognized	187,456	1,619,378
Net cash and cash equivalents used in operating activities	(19,522,014)	(22,918,464)
Cash flows from investing activities:		
Purchase of investments	(61,968,092)	(36,473,649)
Sales of investments	37,012,610	89,590,966
Expenditures for property, buildings, and equipment	(9,699,343)	(7,213,186)
Net cash and cash equivalents (used in) provided by investing activities	(34,654,825)	45,904,131
Cash flows from financing activities:		
Net borrowings under bank lines-of-credit, net	10,559,705	1,448,000
Repayments made under long-term debt	(1,082,500)	(1,032,500)
Net cash and cash equivalents provided by financing activities	9,477,205	415,500
(Decrease) increase in cash and cash equivalents	(44,699,634)	23,401,167
Cash and cash equivalents at beginning of year	81,996,187	58,595,020
Cash and cash equivalents at end of year	$ 37,296,553	$ 81,996,187
Supplemental disclosure of cash flow information:		
Interest paid	$ 654,741	$ 117,393
Income taxes paid	$ -	$ -

See accompanying notes to the consolidated financial statements.

1. Organization and Summary of Significant Accounting Policies

SRC, Inc. (SRC) is a not-for-profit organization that provides services mainly to federal government organizations in a wide array of technology areas, including development and production of sensor systems, signal processing, information science and engineering, cybersecurity, and environmental chemistry and risk assessment.

SRC Ventures, Inc. (Ventures), a for-profit wholly-owned subsidiary pursuant to the laws of the State of New York, conducts activities that are generally not in the furtherance of SRC's exempt purposes as a 501(c)(3) organization under the Internal Revenue Code (the IRC), including, but not limited to, the management and execution of production contracts. Included in Ventures are its wholly owned for-profit subsidiaries: SRCTec, LLC (SRCTec) and SRC Commercial Holdings, Inc. (Commercial Holdings). Included in Commercial Holdings are its wholly-owned for-profit subsidiaries: Acumen Detection, LLC (Acumen); Gryphon Sensors, LLC (Gryphon); and FourV Systems, LLC (FourV). Commercial Holdings was established in September 2017, pursuant to the laws of the State of New York, and conducts activities that are generally not in the furtherance of SRC's exempt purposes as a 501(c)(3) organization under the IRC. Effective March 15, 2018, FourV was sold under an asset purchase agreement. Effective April 25, 2018, the operations and activities of Gryphon ceased and all continued business operations were transferred to and are now performed by SRC.

SRC International, Inc. (International) is a support organization of SRC, Inc. International has qualified as a tax-exempt not-for-profit corporation under Section 509(a)(2) of the IRC. International currently has two wholly-owned for-profit foreign subsidiaries, SRC AUS Pty Ltd (SRC AUS) and SRC CAN Ltd (SRC CAN). These entities were established to provide services mainly to international government organizations in a wide array of technology areas, including information science and engineering.

The significant accounting policies followed by SRC, Ventures and International are described below.

Basis of accounting

The accompanying consolidated financial statements have been prepared on the accrual basis of accounting in conformity with accounting principles generally accepted in the United States of America (U.S. GAAP).

Principles of consolidation

The consolidated financial statements include the accounts of SRC, Ventures, and International as listed above (collectively referred to as the Company). All intercompany balances and transactions have been eliminated in consolidation.

Foreign currency translation and re-measurement

The functional currency of the Company's foreign subsidiaries (SRC AUS and SRC CAN) is their local currency. Net assets are translated at month-end exchange rates while income and expense items are translated at average exchange rates for the applicable period. Translation adjustments are recorded as other non-operating activities in the accompanying consolidated statements of activities and change in unrestricted net assets. Gains and losses resulting from foreign currency denominated transactions are included as a component of costs of revenue in the accompanying consolidated statements of activities and change in unrestricted net assets.

Use of estimates

The preparation of consolidated financial statements in conformity with U.S. GAAP 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. Such estimates also affect the reported amounts of revenues and expenses during the reporting period. Actual results may differ from estimates under different assumptions or conditions.

Operating cycle

The Company's operating cycle for long-term contracts may be greater than one year and is measured by the average time intervening between the inception and the completion of those contracts. Contract-related assets and liabilities are classified as current assets and current liabilities.

Revenue recognition

Revenue is recognized when persuasive evidence of an arrangement exists, services have been rendered or goods delivered, the contract price is fixed or determinable, and collectability is reasonably assured. Revenue associated with work performed prior to the completion and signing of contract documents is recognized only when it can be reliably estimated and realization is probable. The Company bases its estimates on previous experiences with the customer, communications with the customer regarding funding status, and its knowledge of available funding for the contract.

Revenue on cost-plus-fee contracts is recognized to the extent of costs incurred plus a proportionate amount of the fee earned. The Company considers fixed fees under cost-plus-fee contracts to be earned in proportion to the allowable costs incurred in performance of the contract. The Company considers performance-based fees, including award fees, under any contract type to be earned when it can demonstrate satisfaction of performance goals, based upon historical experience, or when the Company receives contractual notification from the customer that the fee has been earned. Revenue on time-and-materials contracts is recognized based on the hours incurred at the negotiated contract billing rates, plus the cost of any allowable material costs and out-of-pocket expenses. Revenue on fixed-price contracts where the Company performs systems design, development and integration is recognized using the percentage-of-completion method of contract accounting. Unless it is determined as part of the Company's regular contract performance review that overall progress on a contract is not consistent with costs expended to date, the Company determines the percentage completed based on the percentage of costs incurred to date in relation to total estimated costs expected upon completion of the contract. Revenue on fixed-price service contracts is generally recognized on a straight-line basis over the contractual service period, unless the revenue is earned, or obligations fulfilled, in a different manner. Revenues on contracts being accounted for under the units of delivery method are generally recognized upon delivery and acceptance or when similar requirements occur.

Contract revenue recognition involves estimation. Provisions for estimated losses on uncompleted contracts are made in the period in which such losses are determined. Changes in job performance, job conditions, and estimated profitability may result in revisions to costs and revenue, and are recognized in the period in which such revisions are determined.

Multiple agencies of the federal government directly or indirectly provided the majority of the Company's contract revenue during the years ended September 30, 2018 and 2017.

Federal government contract costs for 2017 and 2018, including indirect costs, are subject to audit and adjustment by applicable cognizant audit agencies. Contract revenue has been recorded in amounts that are expected to be realized upon final settlement.

Costs of revenue

Costs of revenue include all direct contract costs, as well as indirect overhead costs and selling, general and administrative expenses that are allowable and allocable to contracts under federal procurement standards. Costs of revenue also include costs and expenses that are unallowable and are not allocable to contracts for billing purposes. Such costs and expenses do not directly generate revenue but are necessary for business operations.

Deferred contract costs represent costs incurred on contracts that have not yet been accepted.

Unrestricted net assets

The Financial Accounting Standards Board (the FASB) Accounting Standards Codification (ASC) Topic 958, *Not-For-Profit Entities*, requires not-for-profit organizations to classify net assets into three categories: unrestricted, temporarily restricted, and permanently restricted. The classification is determined based on the presence or absence of donor restrictions. As of September 30, 2018 and 2017, all of the Company's net assets are classified as unrestricted.

Cash equivalents

The Company considers all highly-liquid instruments with original maturities of three months or less to be cash equivalents.

Investments

The Company records its investments at fair value with net unrealized gains and losses included in non-operating activities. Investments with maturities in excess of 12 months from September 30, 2018, and investments held under the deferred compensation plan are classified as noncurrent.

Accounts receivable, unbilled receivables and billings in excess of revenue recognized

Accounts receivable are generated from prime and subcontracting arrangements with federal governmental agencies and various commercial entities. Billed amounts represent invoices that have been prepared and sent to the customer. Unbilled amounts represent costs and anticipated profits not yet billed or awaiting milestones to bill. Management determines reserve for uncollectible accounts by regularly evaluating individual customer receivables and considering a customer's financial condition, credit history, and current economic conditions. Management has recorded an allowance for contract receivables that are considered to be uncollectible. Uncollectible amounts will be written off when all efforts to collect these receivables have been exhausted or when management receives notification that an amount will not be collected.

Billings in excess of revenue recognized represent interim contract billings in excess of costs and estimated earnings incurred on those contracts.

Inventory

Inventory is stated at the lower of cost or net realizable value with cost being determined using the weighted average method. Inventory consists primarily of components and subassemblies and finished products held for sale. Rapid technological change and new product introductions and enhancements could result in excess or obsolete inventory. To minimize this risk, the Company evaluates inventory levels and expected usage on a periodic basis and records adjustments as required.

Property, buildings and equipment

The Company's policy is to capitalize property, buildings and equipment purchases other than software in excess of $2,500. Software is capitalized in excess of $5,000. Property, buildings and equipment are stated at cost. Expenditures for major additions and improvements are capitalized and minor replacements, maintenance, and repairs are charged to expense as incurred. When property and equipment are retired, or otherwise disposed of, the cost and accumulated depreciation and amortization is removed from the accounts and any resulting gain or loss is included in the results of operations for the respective period. Depreciation and amortization of property, buildings and equipment is computed using the straight-line method over the estimated useful lives of the assets. Amortization of leasehold improvements is computed using the straight-line method over the remaining lease term. Land is not depreciated or amortized. Estimated useful lives of the assets are as follows:

Buildings and improvements	15–40 years
Machinery, equipment, and durable tools	5–10 years
Office equipment	5–10 years
Computer equipment and software	3–5 years
Motor vehicles	5 years

Valuation of long-lived assets

The Company reviews the valuation of its long-lived assets for impairment whenever events or circumstances indicate that the carrying amount of an asset group may not be recoverable. Recoverability of the long-lived asset group is measured by a comparison of the carrying amount of the assets to future undiscounted net cash flows expected to be generated by the assets. 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 estimated fair value of the assets. Assets to be disposed of are reported at the lower of the carrying amount or fair value, less costs to sell. No indicators of impairment were identified as of September 30, 2018 and 2017.

Intangible assets

The Company capitalizes costs of software to be sold, leased, or marketed in accordance with ASC 985, *Software*. Included in other assets is approximately $1,684,000 and $2,029,000 of unamortized capitalized software as of September 30, 2018 and 2017, respectively. Amortization expense of approximately $345,000 and $280,000 was recorded for the years ended September 30, 2018 and 2017, respectively.

Other intangible assets were acquired by the Company in 2016 and have a finite useful life of 15 years. Included in other assets is approximately $1,734,000 of other intangible assets relating to a customer list with accumulated amortization of $289,000 and $186,000 at September 30, 2018 and 2017, respectively (see Note 2). Amortization expense of approximately $103,000 and $125,000 was recorded for the years ended September 30, 2018 and 2017, respectively.

Research and development

Research and development costs are expensed in the year incurred. These costs totaled $17,671,000 and $12,176,000 for the years ended September 30, 2018 and 2017, respectively, and are included as a component of indirect expenses in the consolidated statements of activities and change in unrestricted net assets.

Incentive equity plans

FourV was sold on March 15, 2018 through an asset purchase agreement. As a result of the sale, the incentive equity plan no longer exists as of the date of sale.

Prior to the sale of FourV, under the Amended and Restated Operating Agreement of FourV, commencing in fiscal year 2015, profit interests could be granted as compensation to employees of FourV at no cost to the employee and vest over three years. The fair value of each profit interest grant was estimated on the date of grant using the Black-Scholes option valuation model. The compensation expense on time-based profit interests was recorded on a straight-line basis over the vesting period. Profit interests were granted as a percentage membership interest in FourV. The grant date fair values of the profit interests were estimated to have no value, and therefore, no amounts were recorded in the consolidated financial statements.

	Membership Interest
For the year ended September 30, 2017	
Granted	12.0 %
Vested, net of vested forfeitures	5.4
Unvested	6.7 %

Prior to the sale of FourV, under the FourV Systems, LLC Shared Value Plan, commencing in fiscal year 2015, profit interests could be granted as compensation to employees or advisors of FourV at no cost to the employee or advisor and vest over four years or three years, respectively. The fair value of each profit interest grant was estimated on the date of grant using the Black-Scholes option valuation model. The compensation expense on time-based profit interests was recorded on a straight-line basis over the vesting period. There were 200,000 units available to employees and

100,000 units available to advisors. The grant date fair values of the profit interests were estimated to have no value, and therefore, no amounts were recorded in the consolidated financial statements

	Employee Time Based Units	Advisor Time Based Units
For the year ended September 30, 2017		
Granted	154,500	100,000
Vested, net of vested forfeitures	24,875	-
Unvested	129,625	100,000

There were no profit interests granted for either plan during 2018.

Income taxes

SRC, Inc. has qualified as a tax-exempt not-for-profit corporation under Section 509(a)(2) of the IRC and is exempt from federal income taxation on related income pursuant to Section 501(a) of the IRC. International has qualified with the Internal Revenue Service (the IRS) for tax-exempt status as a supporting organization of SRC, Inc. International currently has two wholly-owned for-profit foreign subsidiaries, which are subject to federal income tax. Ventures is a for-profit organization and is subject to federal income tax. The majority of SRC and Ventures' earnings are generated within the United States. SRC AUS is an Australian for-profit organization and is subject to Australian income tax. The majority of SRC AUS earnings are generated within Australia. SRC CAN is a Canadian for-profit organization and is subject to Canadian income tax.

Provisions for income taxes are based on taxes payable or refundable for the current year and deferred taxes on temporary differences between the amount of taxable income and pretax financial income and between the tax basis of assets and liabilities and their reported amounts in the consolidated financial statements. Deferred tax assets and liabilities are included in the consolidated financial statements at currently enacted income tax rates applicable to the period in which the deferred tax assets and liabilities are expected to be realized or settled. As changes in tax laws or rates are enacted, deferred tax assets and liabilities are adjusted through the provision for income taxes.

The provisions of ASC 740, *Income Taxes*, provide recognition criteria and a related measurement model for tax positions taken by the Company. In accordance with ASC 740, a tax position is a position in a previously filed tax return or a position expected to be taken in a future tax filing that is reflected in measuring current or deferred income tax assets and liabilities. Tax positions are recognized only when it is more likely than not (likelihood of greater than 50%), based on technical merits, that the position would be sustained upon examination. Tax positions that meet the more-likely-than-not threshold are measured using a probability-weighted approach as the largest amount of tax benefit that is greater than 50% likely of being realized upon settlement. No liability for uncertain tax positions was recorded by the Company as of September 30, 2018 or 2017. With few exceptions, the Company is no longer subject to income tax examinations by the U.S. federal, state or local tax authorities for the years ended September 30, 2015 and prior.

Fair value of financial instruments

The fair value of the Company's cash and cash equivalents, accounts receivable, accounts payable, and accrued expenses approximate their carrying amounts due to the relatively short maturity of these items. The fair value of the Company's long-term debt approximates its carrying amount due to the variability of the applicable interest rates.

Fair value measurements

Certain assets are recorded at fair value. Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability between market participants in an orderly transaction on the measurement date. The market in which the reporting entity would sell the asset or transfer the liability with the greatest volume and level of activity for the asset or liability is known as the principal market. When no principal market exists, the most advantageous market is used. This is the market in which the reporting entity would sell the asset or transfer the liability with the price that maximizes the amount that would be received or minimizes the amount that would be paid. Fair value is based on assumptions market participants would make in pricing the asset or liability. Generally, fair value is based on observable quoted market prices or derived from observable market data when such market prices or data are available. When such prices or inputs are not available, the reporting entity should use valuation models.

The Company's assets recorded at fair value are categorized based on the priority of the inputs used to measure fair value. Fair value measurement standards require an entity to maximize the use of observable inputs (such as quoted prices in active markets) and minimize the use of unobservable inputs (such as appraisals or other valuation techniques) to determine fair value. The inputs used in measuring fair value are categorized into three levels, as follows:

> Level 1 – Inputs that are based upon quoted prices for identical instruments traded in active markets.
>
> Level 2 – Inputs that are based upon quoted prices for similar instruments in active markets, quoted prices for identical or similar investments in markets that are not active, or models based on valuation techniques for which all significant assumptions are observable in the market or can be corroborated by observable market data for substantially the full term of the investment.
>
> Level 3 – Inputs that are generally unobservable and typically reflect management's estimates of assumptions that market participants would use in pricing the asset or liability. The fair values are therefore determined using model-based techniques that include option pricing models, discounted cash flow models, and similar techniques.

If a financial instrument valuation uses inputs that fall in different levels of the hierarchy, the instrument will be categorized based upon the lowest level of input that is significant to the fair value calculation. The Company's financial assets measured at fair value on a recurring basis are cash equivalents that include a money market fund and short-term investments. The fair value determinations are based upon the unadjusted quoted prices for identical assets in active markets and inputs observable in the marketplace, techniques classified within Level 1 and Level 2, respectively, of the valuation hierarchy described above.

Assets measured at fair value on a recurring basis are summarized below:

	As of September 30, 2018			
	Assets Measured At Fair	Fair Value Hierarchy Level		
Description	Value	Level 1	Level 2	Level 3
Investments:				
Money market funds	$ 667,000	$ 667,000	$ -	$ -
Commercial paper	278,000	278,000	-	-
Mutual funds	21,935,000	21,935,000	-	-
Fixed income funds	593,000	-	593,000	-
Equity funds and ETF	173,735,000	173,735,000	-	-
	$ 197,208,000	$ 196,615,000	$ 593,000	$ -

	As of September 30, 2017			
	Assets Measured At Fair	Fair Value Hierarchy Level		
Description	Value	Level 1	Level 2	Level 3
Investments:				
Money market funds	$ 47,350,000	$ 47,350,000	$ -	$ -
Commercial paper	214,000	214,000	-	-
Corporate and foreign bonds	9,018,000	-	9,018,000	-
Fixed income funds	832,000	-	832,000	-
Equity funds and ETF	153,289,000	153,289,000	-	-
	$ 210,703,000	$ 200,853,000	$ 9,850,000	$ -

Of the above total investments for the years ended September 30, 2018 and 2017, $625,000 and $47,327,000, respectively, is included in cash and cash equivalents; $194,303,000 and $161,006,000, respectively, is classified as investments; and $2,280,000 and $2,370,000, respectively, relates to assets held in the 475(b) plan (see Note 7) and is included in other assets in the accompanying consolidated statements of financial position.

In determining the fair value of its assets and liabilities, the Company predominately uses the market approach. Securities included in Level 2 are valued by the Company's custodian, who uses independent trust accounting services. To determine the fair value of the Company's Level 2 investments, a variety of inputs are utilized, including, but not limited to, benchmark yields, reported trades, broker/dealer quotes, issuer spreads, two-sided markets, benchmark securities, bids, offers, and reference data. The Company reviews the values generated by the independent pricing service for reasonableness. The Company has not adjusted the prices obtained from the independent pricing service.

Interest and dividend income and net realized and unrealized gains on investments were approximately $14,210,000 and $20,280,000, respectively, for the years ended September 30, 2018 and 2017. Of this amount, $5,869,000 and $5,610,000, respectively, represents interest and dividend income and $8,341,000 and $14,670,000, respectively, represents realized and unrealized gains for the years ended September 30, 2018 and 2017.

Postretirement health care benefits

The Company recognizes a liability for their defined benefit postretirement plan's underfunded status in its consolidated statements of financial position. The postretirement plan's assets and obligations that determine its funded status are measured as of the end of the fiscal year. The Company reported the change in the funded status in its consolidated statement of activities and change in unrestricted net assets.

Shipping and handling

Revenues and costs associated with shipping products to customers are included in revenues and direct costs, respectively, on the consolidated statements of activities and change in unrestricted net assets.

Concentrations of credit risk

The Company's assets that are exposed to credit risk consist primarily of cash and cash equivalents, investments, and contract receivables. Cash and cash equivalents are maintained at financial institutions and, at times, balances may exceed federally insured limits. The Company has historically not experienced any losses related to these balances. Amounts on deposit in excess of federally insured limits at September 30, 2018 approximate $36,000,000. Investment securities are exposed to various risks such as interest rate, market, and credit risks. Due to the level of risk associated with certain investments securities, it is at least reasonably possible that changes in the values of investment securities will occur in the near term and that such changes could materially affect the investment balances and the amounts reported in the consolidated statements of financial position. Contract receivables consist primarily of amounts due from various agencies of the federal government or prime contractors doing business with the federal government. Historically, the Company has not experienced significant losses related to contract receivables and, therefore, believes that the credit risk related to contract receivables is minimal.

Functional allocation of expenses

The costs of providing the programs and other activities have been summarized below. Accordingly, certain costs have been allocated among the activities benefited. The disclosure of expenses related to providing services on a functional basis is as follows for the years ended September 30, 2018 and 2017: Program services total $196,805,672 and $152,836,548, respectively, and general and administrative total $118,461,498 and $102,737,208, respectively.

Recently adopted authoritative guidance

In July 2015, the FASB issued guidance to modify current requirements that an entity measure inventory at the lower of cost or market value. Market value could be replacement cost, net realizable value, or net realizable value less an approximately normal profit margin. The guidance does not apply to inventory that is measured using last-in, first-out (LIFO) or the retail inventory method. This guidance applies to all other inventory, which includes inventory that is measured using first-in, first-out (FIFO) or average cost. An entity should measure in scope inventory at the lower of cost and net realizable value. Net realizable value is the estimated selling price in the ordinary course of business, less reasonably predictable costs of completion, disposal, and transportation. Subsequent measurement is unchanged for inventory measured using LIFO or the retail inventory method. The guidance is effective for fiscal years beginning after December 15, 2016, and interim periods within fiscal years beginning after December 15, 2017 and should be applied prospectively with earlier application permitted as of the beginning of an interim or annual reporting period. The adoption of this new standard did not have a significant impact on the carrying value of inventory as of September 30, 2018.

Recent accounting pronouncements not yet adopted

In May 2014, the FASB issued guidance that supersedes previously issued guidance on revenue recognition and will apply to virtually all industries. The core principle of this new guidance is built on the contract between a vendor and a customer for the provision of goods and services. It attempts to depict the exchange of rights and obligations between the parties in the pattern of revenue recognition based on the consideration to which the vendor is entitled. To accomplish this objective, the standard requires five basic steps: (i) identify the contract with the customer, (ii) identify the performance obligations in the contract, (iii) determine the transaction price, (iv) allocate the transaction price to the performance obligations in the contract, and (v) recognize revenue when (or as) the entity satisfies the performance obligation. The new standard will be effective for the Company on October 1, 2019. The Company is currently evaluating the effect that adoption of this new standard will have on the Company's financial statements.

In February 2016, the FASB issued Accounting Standards Update (ASU) 2016-02, *Leases,* related to leasing for both lessees and lessors. The new standard establishes a right-of-use (ROU) model that requires a lessee to record a ROU asset and a lease liability on the statement of financial position for all leases with terms longer than 12 months. Leases will be classified as either finance or operating, with classification affecting the pattern of expense recognition in the statement of activities. The new standard is effective for the Company on October 1, 2020, including interim periods within those fiscal years. A modified retrospective transition approach is required for lessees for capital and operating leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements, with certain practical expedients available. The Company is currently evaluating the effect that adoption of this new standard will have on the Company's financial statements.

In August 2016, the FASB issued ASU 2016-14, *Not-for-Profit Entities (Topic 958) – Presentation of Financial Statements of Not-for-Profit Entities, debt* related to financial reporting for nonprofit entities. The ASU amends the current reporting model for nonprofit organizations and enhances their required disclosures. The major changes include: (a) requiring the presentation of only two classes of net assets now entitled "net assets without donor restrictions" and "net assets with donor restrictions," (b) modifying the presentation of underwater endowment funds and related disclosures, (c) requiring the use of the placed in service approach to recognize the expirations of restrictions on gifts used to acquire or construct long-lived assets absent explicit donor stipulations otherwise, (d) requiring that all nonprofits present an analysis of expenses by function and nature in either the statement of activities, a separate statement, or in the notes and disclose a summary of the allocation methods used to allocate costs, (e) requiring the disclosure of quantitative and qualitative information regarding liquidity and availability of resources, (f) presenting investment return net of external and direct internal investment expenses, and (g) modifying other financial statement reporting requirements and disclosures intended to increase the usefulness of nonprofit financial statements. The new guidance is effective for the Company's financial statements as of October 1, 2018. The provisions of the ASU must be applied on a retrospective basis for all years presented although certain optional practical expedients are available for periods prior to adoption. The Company is currently evaluating the effect that adoption of this new standard will have on the Company's financial statements.

In March 2017, FASB issued ASU 2017-07, *Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost.* This update applies to any employer that sponsors a defined benefit pension plan, other postretirement benefit plan, or other types of benefits accounted for under Topic 715. The amendments in this ASU require that an employer report the service cost component in the same line item or items as other compensation costs arising from services rendered by the pertinent employees during the period. The other components of net benefit cost, as defined in Topic 715, are required to be presented in the consolidated statements of activities separately from the service cost component and outside a subtotal of income from operations, if one is presented. If a separate line item or items are used to present the other components of net benefit cost, that line item or items must be appropriately described. If a separate line item or items are not used, the line item or items used in the consolidated statements of activities to present the other components of net benefit cost must be disclosed. The amendments in this ASU also allow only the service cost component to be eligible for capitalization when applicable. The guidance is effective for the Company beginning October 1, 2019. Early adoption is permitted. The Company is currently evaluating the effect that adoption of this new standard will have on the Company's financial statements.

Reclassifications

Certain amounts in the 2017 consolidated financial statements have been reclassified to conform to the 2018 presentation, primarily due to a change in the presentation of certain components of non-operating activities. Previously, these components were identified as additional changes to unrestricted net assets versus the non-operating section. The effect of the reclassification from including as changes to unrestricted net assets to non-operating activities was an increase to the change in net assets before benefit from income taxes of approximately $1.3 million. There was no effect on beginning or ending unrestricted net assets for 2017.

2. Business Combinations

On March 31, 2016, SRC AUS acquired certain assets of a small engineering services company known as Mission Data Solutions Pty Ltd for a purchase price of approximately $4,700,000. The purpose of the acquisition was to assist in gaining access to business opportunities with the Australian Government. Included in the purchase price is approximately $2,056,000 of contingent consideration for an earn-out. The earn-out liability was fully satisfied as of September 30, 2018. As of September 30, 2017, approximately $2,056,000 of the earn-out liability is included in accrued expenses in the accompanying consolidated statements of financial position. The earn-out consists of two payments that are determined based on SRC consolidated revenues from SRC AUS, on a cumulative basis.

3. Inventory

Inventory consists of the following at September 30:

	2018	2017
Work-in progress and finished goods	$ 27,547,374	$ 7,526,766
Purchased parts	41,973,596	18,335,529
	$ 69,520,970	$ 25,862,295

As of September 30, 2018 and 2017, the Company recorded reserves for excess or obsolete inventory of approximately $2,779,000 and $2,740,000, respectively.

4. Property, Buildings and Equipment

Property, buildings and equipment consists of the following at September 30:

	2018	2017
Land	$ 793,857	$ 793,857
Building and building improvements	40,713,388	40,294,684
Equipment	63,108,873	56,751,985
Computer software	8,561,834	8,262,106
Leasehold improvements	13,193,346	10,569,323
	126,371,298	116,671,955
Less: accumulated depreciation and amortization	(80,061,693)	(74,481,309)
	$ 46,309,605	$ 42,190,646

Depreciation and amortization expense on property and equipment approximated $5,580,000 and $5,759,000 and includes $448,000 and $516,000 related to internal-use capitalized software for the years ended September 30, 2018 and 2017, respectively.

5. Lines-of-credit and Long-term Debt

Lines-of-credit

SRC has available a $10,000,000 line-of-credit with a bank. The outstanding amounts under the line-of-credit are unsecured and bear interest at 1.50% above one-month London Interbank Offered Rate (LIBOR), adjusting daily (2.26% at September 30, 2018). No amounts were outstanding under the line as of September 30, 2018 or 2017.

Ventures has available a $35,000,000 line-of-credit with a bank, of which any outstanding amounts under this line-of-credit are unsecured and bear interest at the greater of (a) 2.25% above one-month LIBOR, adjusting daily (2.26% at September 30, 2018) or (b) 3.25% per annum. Amounts outstanding under the line at September 30, 2018 and 2017 total $12,008,000 and $1,448,000, respectively.

Long-term Debt

Long-term debt consists of the following at September 30:

	2018	2017
1997A Series Onondaga County Industrial Development Agency (IDA) Mars Civic Facility Revenue Bonds. Revenue Bonds, payable quarterly, commencing March 1, 1998 through December 2021, of principal plus interest, at a variable rate determined on a weekly basis using SIFMA index (1.56% at September 30, 2018) plus 0.05%. The obligation is collateralized by a letter of credit in the amount of $1,978,000.	$ 1,577,500	$ 2,000,000
2005 Series Onondaga County Industrial Development Agency Variable Rate Demand Civic Facility Revenue Bonds. Revenue Bonds, payable quarterly, commencing December 1, 2007 through December 2031, of principal plus interest, at a variable rate determined on a weekly basis using SIFMA index (1.56% at September 30, 2018) plus 0.05%. The obligation is collateralized by a letter of credit in the amount of $11,682,000.	11,540,000	12,200,000
	13,117,500	14,200,000
Less: long-term debt – current portion	(1,132,500)	(1,082,500)
Long-term debt, net of current portion	11,985,000	13,117,500
Less: unamortized debt issuance costs	(292,000)	(315,000)
Long-term debt, net of unamortized debt issuance costs	$ 11,693,000	$ 12,802,500

As of September 30, 2018, debt obligation maturities are as follows:

Years ending September 30,	
2019	$ 1,132,500
2020	1,182,500
2021	1,232,500
2022	870,000
2023	760,000
Thereafter	7,940,000
	$ 13,117,500

The letters of credit collateralizing the 1997A Series IDA bonds and the 2005 Series IDA bonds contain a restrictive financial covenant pertaining to cash-to-debt ratio. The Company was in compliance with this covenant at September 30, 2018 and 2017.

6. Income Taxes

Significant components of the benefit from (provision for) income taxes are as follows for the years ended September 30:

		2018		2017
Current income tax expense	$	(689,030)	$	(3,122)
Deferred income tax benefit		4,140,331		95,046
Benefit from income taxes	$	3,451,301	$	91,924

The net deferred taxes are comprised of the following for the years ended September 30:

		2018		2017
U.S. operations				
Deferred tax liability:				
Depreciation	$	892,200	$	278,300
Total deferred tax liability		892,200		278,300
Deferred tax assets:				
Allowances for inventory		465,300		959,100
Start-up costs		38,000		84,400
Inventory capitalization		429,000		306,600
Net operating loss		3,368,527		10,543,123
Warranty and other reserves		413,200		2,599,200
Benefits reserve		274,900		313,300
Charitable contributions		-		283,100
Other		15,500		52,300
Total deferred tax asset		5,004,427		15,141,123
Net deferred tax asset, before valuation allowance		4,112,227		14,862,823
Valuation allowance		-		(14,862,823)
Net deferred tax assets	$	4,112,227	$	-

		2018		2017
Foreign operations				
Deferred tax assets				
Net operating loss	$	125,850	$	97,747
Valuation allowance		-		-
Net deferred tax assets	$	125,850	$	97,747

On December 22, 2017, H.R.1, known as the "Tax Cuts and Jobs Act," was signed into law. Among other things, the Tax Cuts and Jobs Act permanently lowers the corporate tax rate to 21% from the previous maximum rate of 35%, effective for tax years including or commencing January 1, 2018. As a result of the reduction of the corporate tax rate to 21%, U.S. GAAP requires companies to re-value their deferred tax assets and liabilities as of the date of enactment, with resulting tax effects accounted for in the reporting period of enactment.

As of September 30, 2017, the Company had U.S. net deferred tax assets of $14,862,823. The Company recorded a re-valuation of its deferred tax assets and liabilities as of September 30, 2018, at the new rate of 21%, based upon balances in existence at date of enactment. The result of the net deferred tax assets being written down was a reduction in the asset and corresponding increase to tax expense of $5,920,450.

The above deferred income tax balances reflect the effects of temporary differences between the carrying amounts of assets and liabilities and their tax bases, as well as from net operating losses. Those balances are stated at the enacted tax rates expected to be in effect when the Company pays or recovers the taxes. Deferred income tax assets represent amounts available to reduce income taxes the Company will pay on taxable income in future years. The Company evaluates the ability to realize these future tax deductions by assessing whether the Company expects to have sufficient future taxable income from all sources, including reversal of taxable temporary differences, forecasted operating earnings and available tax planning strategies to utilize these future deductions and credits. The Company establishes a valuation allowance when it no longer considers it more likely than not that a deferred tax asset will be realized. A valuation allowance of $14,862,823 was recorded against its gross deferred tax asset balance as of September 30, 2017. For the year ended September 30, 2018, the Company released the balance of the valuation allowance, on the basis of management's reassessment of the amount of its deferred tax assets that are more likely than not to be realized. As of each reporting date, the Company's management considers new evidence, both positive and negative, that could impact management's view with regard to future realization of deferred tax assets. As of September 30, 2018, management determined that sufficient positive evidence exists to conclude that it is more likely than not that the deferred tax assets are realizable, and therefore, reduced the valuation allowance accordingly.

In 2018 and 2017, SRC AUS operations resulted in taxable income of approximately $1,589,000 and $120,600, respectively.

As of September 30, 2018 and 2017, the Company has net operating loss carryforwards of approximately $15,334,600 and $29,309,000, respectively, which will be available to offset future taxable income. The net operating loss carryforwards expire, if not utilized, in fiscal years beginning 2023 and forward.

7. Benefit Plans

Defined Contribution Retirement Plans

All employees of the Company are covered under the TIAA and CREF plans. Participation in the plans is mandatory on the first day of the month following date of hire for all employees age 21 and older. Participants are required to contribute, at a minimum, 5% of compensation. The Company makes contributions to the plan on a monthly basis equal to 10% of the eligible employees' compensation. During the years ended September 30, 2018 and 2017, the amount contributed by the Company to the defined contribution pension plans was approximately $10,981,000 and $9,472,000, respectively.

457(b) Plan

The Company provides an unfunded 457(b) deferred compensation plan (the 457(b) Plan) that allows for participation by board members and senior management. Participants may contribute a portion of their compensation up to the maximum IRS limitations each year. The Company contributed approximately $214,000 and $200,000 during the years ended September 30, 2018 and 2017, respectively. Plan contributions are held in investment funds with TIAA and CREF and M&T Investment Group. The plan assets are owned by the Company until the participant has a distributable event. Participant contributions were approximately $215,000 and $294,000 in 2018 and 2017, respectively. As of September 30, 2018 and 2017, the 457(b) Plan assets and obligations totaled approximately $2,280,000 and $2,370,000, respectively, and are included in long-term other assets and other long-term liabilities in the accompanying consolidated statements of financial position.

Postretirement Health Care Benefits Plan

The Company provides the SRC Total Care Plan (the Plan) to provide welfare benefits, including medical, dental, prescription drugs, and life insurance, to substantially all currently active employees as well as life insurance benefits to retired employees. On February 12, 2018, the Company adopted a plan amendment to the postretirement life insurance plan that revised the eligibility criteria of the retiree group health benefits program from age 62 with at least 10 years of service after age 52 to the Rule of 72 (the sum of age and years of service must be at least 72), with a minimum age of 55 and minimum of 10 years of service on or after age 62 with at least ten years of continuous service as a full-time employee. The retiree medical benefits shall be provided pursuant to an insured Medicare supplement arrangement. The retiree medical eligibility provisions of the Plan provide that only former employees of the Company who (1) retired after attaining age 65 and have completed ten years of continuous full-time employment with the Company or (2) retired after attaining age 62 but prior to age 65, and have completed ten years of continuous full-time employment with the Company, and have attained age 65, are eligible for retiree medical benefits under the Plan.

On October 1, 2016, the Company communicated to plan participants that, effective January 1, 2017, the Plan was amended to (a) eliminate all self-funded medical coverage under the Plan for retirees and their spouses such that the last day self-funded retiree medical coverage was available under the Plan was December 31, 2016, (b) allow dependent children of eligible retirees who are currently participating in the Plan's self-funded medical benefit to continue coverage under the Plan's insured medical benefit option after December 31, 2016, until they are no longer considered eligible dependents under the terms of the Plan and (c) increase the amount of life insurance coverage offered under the Plan for eligible retirees to $10,000 subject to any restrictions or requirements. At that time, existing plan assets were used to offset employee and retiree health claims.

The following table presents the change in the postretirement and health care benefit obligation in the consolidated statements of financial position for the years ended September 30:

		2018		2017
Change in benefit obligation				
Benefit obligation at beginning of year	$	762,496	$	2,185,918
Service cost		68,886		71,125
Interest cost		38,684		24,837
Amendments		408,923		(1,306,245)
Actuarial gain		(102,757)		(213,139)
Benefits paid		(10,000)		-
Benefit obligation at end of year	$	1,166,232	$	762,496

The underfunded status is recorded in other long-term liabilities in the accompanying consolidated statements of financial position as follows as of September 30:

		2018		2017
Change in plan assets				
Fair value of plan assets at beginning of year	$	-	$	2,015,523
Actual return on plan assets		-		17,894
Distributions to the employer		10,000		(2,033,417)
Benefits paid		(10,000)		-
Fair value of plan assets at end of year		-		-
Underfunded status	$	(1,166,232)	$	(762,496)

As of September 30, 2018 and 2017, the Plan had unamortized actuarial net losses of approximately $246,000 and $373,000, respectively, and unamortized prior service credit of $476,000 and $1,109,000, respectively.

Weighted average assumptions used to calculate the benefit obligation are as follows as of September 30:

	2018	2017
Expected return on plan assets	0.00%	0.00%
Discount rate	4.20%	3.81%

Weighted average assumptions used to calculate the net periodic benefit (income) cost are as follows for the years ended September 30:

	2018	2017
Expected return on plan assets	0.00%	0.00%
Discount rate	3.81%	3.57%

Components of net periodic benefit (income) cost are as follows for the years ended September 30:

	2018	2017
Components of net periodic benefit (income) cost		
Service cost	$ 68,886	$ 71,125
Interest cost	38,684	24,837
Amortization of prior service credit	(224,207)	(314,724)
Amortization of net loss	23,921	28,681
	$ (92,716)	$ (190,081)

Components of net periodic benefit cost recognized in non-operating activities in the accompanying consolidated statements of activities and change in unrestricted net assets for the years ended September 30 are as follows:

	2018	2017
Prior service cost (credit)	$ 408,923	$ (1,306,245)
Actuarial gain	(102,757)	(231,033)
Amortization of prior service cost	224,207	314,724
Amortization of actuarial gain	(23,921)	(28,681)
	$ 506,452	$ (1,251,235)

Expected benefit payments reflect expected future services. Shown below are the expected gross benefit payments (including prescription drug benefits) for the following fiscal years. The Company does not expect to receive any subsidy payments during the next ten fiscal years.

	Net Payments
2019	$ 15,838
2020	17,422
2021	19,372
2022	21,556
2023	23,885
Years 2024-2028	166,002

Plan Assets

Plan assets consisted of cash and cash equivalents of $2,015,523 at September 30, 2016, and were then distributed to the Company during fiscal year 2017. There are no plan assets as of September 30, 2018 and 2017.

8. Major Customers

For the years ended September 30, 2018 and 2017, customers within the U.S. Federal Government (principally Army, Air Force, and Department of Defense organizations within the intelligence community and Environmental Protection Agency), accounted for 96.1% and 95.1%, respectively, of the Company's revenue. As of September 30, 2018 and 2017, the U.S. Federal Government represents 92.8% and 84.1%, respectively, of the total contract receivables balance.

9. Commitments and Contingencies

Commitments

The Company leases office space and certain equipment under the terms of noncancelable operating leases that expire at various dates through 2026. The Company is also responsible for certain operating expenses. The following is a schedule by year of the future minimum lease payments required under these leases which have initial or remaining terms in excess of one year as of September 30, 2018:

Years ending September 30,	Operating Leases
2019	$ 3,643,000
2020	3,273,000
2021	2,922,000
2022	2,393,000
2023	2,026,000
Thereafter	5,569,000
Total minimum payments	$ 19,826,000

The Company recognizes the total cost of its office leases ratably over the respective lease periods. The difference between rent paid and rent expense is included in other long-term liabilities in the accompanying consolidated statements of financial position. Rent expense aggregated approximately $3,674,000 and $3,381,000 for the years ended September 30, 2018 and 2017, respectively, which is included as a component of indirect expenses in the accompanying consolidated statements of activities and change in unrestricted net assets.

Contingencies

In 2015, the Company undertook a product recalibration for a customer. As of September 30, 2015, the cost of the recalibration was estimated at $3,100,000 of which approximately $905,000 and $2,207,000 remains in accrued expenses in the consolidated financial statements related to the estimated recalibration cost as of September 30, 2018 and 2017, respectively. In 2016, the Company accrued an additional $6,300,000 in connection with an anticipated settlement of a civil False Claims Act recovery by the U.S. Government associated with this matter. As of September 30, 2017, $4,173,000 is included in accrued expenses in the accompanying consolidated financial statements. This liability was satisfied as of September 30, 2018.

10. Subsequent Events

The Company has evaluated its September 30, 2018 consolidated financial statements for subsequent events through December 19, 2018, the date the consolidated financial statements were available to be issued. The Company is not aware of any subsequent events which would require recognition or disclosure in the consolidated financial statements.

Schedule of Expenditures of Federal Awards

SRC, Inc. and Subsidiaries

Schedule of Expenditures of Federal Awards

Year Ended September 30, 2018

Federal Grantor/Program Title	Federal CFDA Number	Contract Number / Pass-Through Entity	2018 Federal Expenditures	Amounts Provided to Subrecipients
Research and Development Cluster				
U.S. Department of Defense				
Direct Programs Department of the Air Force	12.RD		$ 46,407,780	$ -
Pass-Through Programs From:				
ALION SCIENCE AND TECHNOLOGY	12.RD	SUB1143302	1,017,561	-
AVARINT, LLC	12.RD	A0050.40S2	24,163	-
BLACK RIVER SYSTEMS	12.RD	1725-S01-BRSC	131,081	-
BOOZ-ALLEN	12.RD	S901088BAH T.O. 1	47,475	-
BOOZ-ALLEN	12.RD	S901411BAH	46,895	-
BOOZ-ALLEN	12.RD	107195SB4E	132,334	-
BOOZ-ALLEN	12.RD	107234SB31	103,404	-
BOOZ-ALLEN	12.RD	S900334BAH	142,469	-
CAS, INC.	12.RD	CAS SC 686-18	1,805	-
DEFENSE RESEARCH ASSOCIATES	12.RD	SRC-1797	223,820	-
DYNETICS	12.RD	DI-SC-16-05	272,214	-
HARRIS CORPORATION	12.RD	17-30102-916202	176,216	-
INNOVATIVE SIGNAL ANALYS	12.RD	536-SRC-01	137	-
LEIDOS, INC	12.RD	P010191561	518,412	-
MATRIX RESEARCH, INC.	12.RD	CRFR-017	183,511	-
NORTHROP GRUMMAN	12.RD	7500151950	440,489	-
NORTHROP GRUMMAN	12.RD	7500156052	2,654,165	-
RADIANCE TECHNOLOGIES	12.RD	17S-1216	43,017	-
ROCKWELL COLLINS	12.RD	CW2248651	12,063	-
SIERRA NEVADA CORP	12.RD	S17TNH076	109,194	-
SMARTRONIX, INC	12.RD	15R09S	236,077	-
Total Department of the Air Force			52,924,282	-

SRC, Inc. and Subsidiaries

Schedule of Expenditures of Federal Awards

Year Ended September 30, 2018

Federal Grantor/Program Title	Federal CFDA Number	Contract Number / Pass-Through Entity	2018 Federal Expenditures	Amounts Provided to Subrecipients
Research and Development Cluster				
Direct Programs Department of the Army	12.RD		45,670,314	-
Pass-Through Programs From:				
ATI	12.RD	2017-324	3,535,924	-
ATI	12.RD	2017-351 #1	1,459,422	-
BOOZ-ALLEN	12.RD	107204SB60	597,156	-
BOOZ-ALLEN	12.RD	98596XSB0P	7,722,241	-
CACI TECH	12.RD	P000007826	537,007	-
CACI TECH	12.RD	P000024474	(43)	-
CACI TECH	12.RD	P000042278	703	-
ENGILITY CORP	12.RD	2015-S-EGL-0122	280,596	-
EOIR TECHNOLOGIES, INC	12.RD	S16-10017	4,415,537	-
KORD TECHNOLOGIES, INC.	12.RD	OTA KSC-18-014	63,626	-
LOCKHEED MARTIN	12.RD	4102624252	2,426	-
LOCKHEED MARTIN	12.RD	4102695903	325	-
LOCKHEED MARTIN	12.RD	4102744130	24,659	-
LOCKHEED MARTIN	12.RD	4103583566	9,494	-
LOCKHEED MARTIN	12.RD	4103677531	7,133	-
NORTHROP GRUMMAN	12.RD	8200217311	159,705	-
PRA	12.RD	PRA-SC-15-001	54,226	-
RADIANCE TECHNOLOGIES	12.RD	18S-0249	192,475	-
SAIC	12.RD	P010204667	5,581,532	-
SAIC	12.RD	P010204667/2	256,004	-
SAVIT CORP	12.RD	7D03-N-3590	3,138	-
SIERRA NEVADA CORP	12.RD	S17TNH112	344,862	-
SPECTRAL SCIENCES, INC.	12.RD	#3517-001-47	27,733	-
SRCTEC, LLC	12.RD	I100305	6,274	-
SRCTEC, LLC	12.RD	I100307	1,337,473	-
SRCTEC, LLC	12.RD	I100328	3,011	-
SRCTEC, LLC	12.RD	I100341	13,100	-

SRC, Inc. and Subsidiaries

Schedule of Expenditures of Federal Awards

Year Ended September 30, 2018

Federal Grantor/Program Title	Federal CFDA Number	Contract Number / Pass-Through Entity	2018 Federal Expenditures	Amounts Provided to Subrecipients
Research and Development Cluster				
SRCTEC, LLC	12.RD	I100346 Lines 1&2	23,065	-
SRCTEC, LLC	12.RD	I100346 Lines 3&4	12,217	-
SRCTEC, LLC	12.RD	I100353	49,155	-
SRCTEC, LLC	12.RD	I100355	63	-
SRCTEC, LLC	12.RD	I100369	629,318	-
SRCTEC, LLC	12.RD	I100387	53,316	-
SRCTEC, LLC	12.RD	I100389	40,240	-
SRCTEC, LLC	12.RD	I100423	21,112	-
SRCTEC, LLC	12.RD	I100451 Lines 1 & 2	47,099	-
SRCTEC, LLC	12.RD	I100468	238	-
SRCTEC, LLC	12.RD	PO I100045	6,752	-
SRCTEC, LLC	12.RD	PO I100130	394,184	-
SRCTEC, LLC	12.RD	PO I100163	96,506	-
SRCTEC, LLC	12.RD	PO I100226 Item 6&7	8,601	-
SRCTEC, LLC	12.RD	PO I100270	51,238	-
Total Department of the Army			73,739,157	-
Direct Programs Department of the Navy	12.RD		2,010,148	-
Pass-Through Programs From:				
AMEWAS, INC	12.RD	PO017-01456	44,213	-
J.F.TAYLOR, INC	12.RD	JFT-0016-21	592,350	-
LEIDOS, INC	12.RD	4103000004	1,500,121	-
NORTHROP GRUMMAN	12.RD	4700001709	196,958	-
NSI	12.RD	SMA-SRC-01	48,975	-
Total Department of the Navy			4,392,765	-

SRC, Inc. and Subsidiaries

Schedule of Expenditures of Federal Awards

Year Ended September 30, 2018

Federal Grantor/Program Title	Federal CFDA Number	Contract Number / Pass-Through Entity	2018 Federal Expenditures	Amounts Provided to Subrecipients
Research and Development Cluster				
Department of the Marines				
Pass-Through Programs From:				
NORTHROP GRUMMAN	12.RD	8200209192	38,144	-
NORTHROP GRUMMAN	12.RD	8140000947	4,145	-
SRCTEC, LLC	12.RD	I100311	53,396	-
SRCTEC, LLC	12.RD	I100432 Line 1&2	7,161	-
Total Department of the Marines			102,846	-
National Security Agency				
Pass-Through Programs From:				
EXCEPTIONAL SW STRATEGIES	12.RD	H98230-14-D-0154-SC-20	179,977	-
Total National Security Agency			179,977	-
Direct Programs National Reconnaissance Organization	12.RD		1,183,379	-
Pass-Through Programs From:				
PARSONS	12.RD	NA	876,149	-
VENCORE, INC.	12.RD	NA	489,315	-
Total National Reconnaissance Organization			2,548,843	-
Defense Intelligence Agency				
Pass-Through Programs From:				
COLSA CORPORATION	12.RD	HS-161113	76,341	-
Total Defense Intelligence Agency			76,341	-

SRC, Inc. and Subsidiaries

Schedule of Expenditures of Federal Awards

Year Ended September 30, 2018

Federal Grantor/Program Title	Federal CFDA Number	Contract Number / Pass-Through Entity	2018 Federal Expenditures	Amounts Provided to Subrecipients
Research and Development Cluster				
Direct Programs Defense Advanced Research Projects Agency	12.RD		7,429,226	-
Total Defense Advanced Research Projects Agency			7,429,226	-
Direct Programs Defense Threat Reduction Agency	12.RD		847,157	-
Pass-Through Programs From:				
CACI, INC.-FEDERAL	12.RD	P000030899	5,172,401	-
URS CORP.	12.RD	URSFS48542	24,209	-
URS CORP.	12.RD	URSFS48832	12,392	-
Total Defense Threat Reduction Agency			6,056,159	-
Defense Logistics Agency				
Pass-Through Programs From:				
SRCTEC, LLC	12.RD	I100424	6,027	-
SRCTEC, LLC	12.RD	I100466 LINES 1 & 2	798	-
Total Defense Logistics Agency			6,825	-
Other Contracts	12.RD		2,873,532	-
Total U.S. Department of Defense			150,329,953	-

SRC, Inc. and Subsidiaries

Schedule of Expenditures of Federal Awards

Year Ended September 30, 2018

Federal Grantor/Program Title	Federal CFDA Number	Contract Number / Pass-Through Entity	2018 Federal Expenditures	Amounts Provided to Subrecipients
Research and Development Cluster				
Environmental Protection Agency				
Direct Programs Environmental Protection Agency	66.RD		4,874,003	-
Pass-Through Programs From:				
LOCKHEED MARTIN	66.RD	46033416	1,113,747	-
SUMMITEC CORPORATION	66.RD	16-10-011	55,289	-
VERSAR, INC.	66.RD	MSA2017-02	19,652	-
Total Environmental Protection Agency			6,062,691	-
U.S. Department of Health and Human Services				
Direct Programs Center for Disease Control and Prevention	93.RD		1,357,857	-
Direct Programs National Library of Medicine	93.RD		373,549	-
Total U.S. Department of Health and Human Services			1,731,406	-
U.S. Department of Homeland Security				
Direct Programs Department of Homeland Security	97.RD		23,045	-
Pass-Through Programs From:				
BATELLE MEMORIAL	97.RD	US001-0000574611	108,150	-
Total U.S. Department of Homeland Security			131,195	-

SRC, Inc. and Subsidiaries

Schedule of Expenditures of Federal Awards

Year Ended September 30, 2018

Federal Grantor/Program Title	Federal CFDA Number	Contract Number / Pass-Through Entity	2018 Federal Expenditures	Amounts Provided to Subrecipients
Research and Development Cluster				
U.S. Department of State				
Pass-Through Programs From:				
SRCTEC, LLC	19.RD	I100254	1,286,585	-
SRCTEC, LLC	19.RD	I100436	1,546	-
Total U.S. Department of State			1,288,131	-
U.S. Department of Transportation				
Direct Programs Federal Aviation Administration	20.RD		69,211	-
Pass-Through Programs From:				
UNIVERSITY OF ILLINOIS	20.RD	P1409725	155	-
Total Federal Aviation Administration			69,366	-
Federal Highway Administration				
Pass-Through Programs From:				
AIRWAYS NZ LTD	20.RD	60067188	13,267	-
Total Federal Highway Administration			13,267	-
Total U.S. Department of Transportation			82,633	-

SRC, Inc. and Subsidiaries

Schedule of Expenditures of Federal Awards

Year Ended September 30, 2018

Federal Grantor/Program Title	Federal CFDA Number	Contract Number / Pass-Through Entity	2018 Federal Expenditures	Amounts Provided to Subrecipients
Research and Development Cluster				
U.S. Department of Energy				
Pass-Through Programs From:				
BATELLE MEMORIAL	81.RD	413738	18,555	-
Total U.S. Department of Energy			18,555	-
National Aeronautics and Space Administration				
Direct Programs National Aeronautics and Space Administration	43.RD		44,743	-
Pass-Through Programs From:				
LJT & ASSOCIATES, INC	43.RD	6210-SRC-001	12,318	-
Total National Aeronautics and Space Administration			57,061	-
Office of the Director of National Intelligence				
Pass-Through Programs From:				
SYRACUSE UNIVERSITY	12.RD	29165-04567-S03	1,038,140	-
Total Office of the Director of National Intelligence			1,038,140	-
			$ 160,739,765	$ -

The accompanying notes are an integral part of the schedule.

1. Basis of Presentation

The accompanying Schedule of Expenditures of Federal Awards (the Schedule) includes the federal award activity of SRC, Inc. and Subsidiaries (SRC or the Company) under programs of the federal government for the year ended September 30, 2018. The information in this Schedule is presented in accordance with the requirements of Title 2 U.S. Code of Federal Regulations (CFR) Part 200, *Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards* (Uniform Guidance). Because the Schedule presents only a selected portion of the operations of the Company, it is not intended to and does not present the financial position, changes in net assets or cash flows of the Company.

All of the Company's federal awards were in the form of cash assistance for the year ended September 30, 2018. The Company had no federally funded insurance programs or loan guarantees during the year ended September 30, 2018.

2. Summary of Significant Accounting Policies

Expenditures reported on the Schedule are reported on the accrual basis of accounting. Such expenditures are recognized following, as applicable, either the cost principles in Office of Management and Budget (OMB) Circular A-122, *Cost Principles for Non-Profit Organizations,* or the cost principles contained in Title 2 U.S. CFR Part 200, *Uniform Administrative Requirements, Cost Principles and Audit Requirements for Federal Awards*, wherein certain types of expenditures are not allowable or are limited as to reimbursement.

3. Indirect Cost Rate

Direct and indirect costs are charged to awards in accordance with cost principles contained in the Federal Acquisition Regulation (FAR) Part 31 and the Cost Accounting Standards.

The Company recovers indirect costs under contracts and grants at provisional rates negotiated between itself and the cognizant agency (U.S. Department of Defense). Separate indirect cost rates are negotiated for fringe benefits, management overhead, facilities overhead, bid and proposal/ independent research and development costs, general and administrative costs, material handling, and subcontracting costs. Final indirect costs for each fiscal year are determined by the Defense Contract Audit Agency (DCAA) upon subsequent annual audits at which point cost reimbursement contracts are settled at actual rates. A detailed schedule of indirect cost rates is included in the DCAA annual incurred costs report for the year ended September 30, 2018.

The Company has elected not to use the 10 percent de minimis indirect cost rate allowed under the Uniform Guidance.

4. Other Contracts

Other contracts, referred to in the Schedule, primarily consist of federal contracts the Company has entered into that are of a sensitive nature which were subject to audit by a branch of the DCAA that monitors classified contracts.

Independent Auditor's Reports Required by *Government Auditing Standards* and the Uniform Guidance

Tel: 703-893-0600
Fax: 703-893-2766
www.bdo.com

8401 Greensboro Drive
Suite 800
McLean, VA 22102

Independent Auditor's Report on Internal Control Over Financial Reporting and on Compliance and Other Matters Based on an Audit of Consolidated Financial Statements Performed in Accordance With *Government Auditing Standards*

Board of Directors
SRC, Inc. and Subsidiaries
Syracuse, New York

We have audited, in accordance with the 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, the consolidated financial statements of SRC, Inc. and Subsidiaries (the Company) which comprise the consolidated statement of financial position as of September 30, 2018, and the related consolidated statement of activities and change in unrestricted net assets and cash flows for the year then ended, and the related notes to the consolidated financial statements, and have issued our report thereon dated December 19, 2018.

Internal Control Over Financial Reporting

In planning and performing our audit of the consolidated financial statements, we considered the Company's internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinion on the consolidated financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control. Accordingly, we do not express an opinion on the effectiveness of the Company's internal control.

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 a combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's consolidated financial statements will not be prevented, or detected and corrected on a timely basis. *A significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Our consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies. Given these limitations, during our audit we did not identify any deficiencies in internal control that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Company's consolidated financial statements are free from 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 consolidated 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*.

Purpose of this Report

The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the results of that testing, and not to provide an opinion on the effectiveness of the entity's internal control or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the entity's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.

BDO USA, LLP

McLean, Virginia
December 19, 2018

Tel: 703-893-0600
Fax: 703-893-2766
www.bdo.com

8401 Greensboro Drive
Suite 800
McLean, VA 22102

Independent Auditor's Report on Compliance for the Major Federal Program and Report on Internal Control over Compliance Required by the Uniform Guidance

Board of Directors
SRC, Inc. and Subsidiaries
Syracuse, New York

Report on Compliance for the Major Federal Program

In connection with the coordinated audit of SRC, Inc. and Subsidiaries (the Company) as provided for in U.S. Office of Management and Budget (OMB) *Compliance Supplement*, the U.S. Defense Contract Audit Agency (DCAA) and BDO USA, LLP (BDO) each performed certain tasks. Responsibilities under the coordinated audit approach were assigned as follows:

1. BDO performed specific audit procedures over all federal awards of the research and development cluster major federal program for the cash management compliance as described in the OMB *Compliance Supplement*.

2. BDO performed specific audit procedures over non-classified federal awards of the research and development cluster major federal program for all federal agencies for the following compliance requirements as described in the OMB *Compliance Supplement*:

   - Equipment and Real Property Management
   - Matching, Level of Effort and Earmarking
   - Procurement, Suspension and Debarment
   - Program Income
   - Reporting
   - Subrecipient Monitoring
   - Special Tests and Provisions

3. BDO performed specific audit procedures over the direct costs of federal awards from the U.S. Environmental Protection Agency (EPA) for the following compliance requirements as described in the OMB *Compliance Supplement*:

   - Activities Allowed or Unallowed
   - Allowable Cost/Cost Principles
   - Period of Availability of Federal Funds/Period of Performance

4. BDO tested the internal control over compliance with respect to the above listed compliance requirements described as BDO's responsibility as they related to the federal awards of the research and development cluster major federal program.

5. DCAA performed all audit procedures over the classified federal awards from all agencies of the research and development cluster major federal program for the following compliance requirements as described in the OMB *Compliance Supplement*:

   - Equipment and Real Property Management
   - Matching, Level of Effort and Earmarking
   - Procurement, Suspension and Debarment
   - Program Income
   - Reporting
   - Subrecipient Monitoring
   - Special Test and Provisions

6. DCAA performed all audit procedures over all federal awards (indirect and direct costs) from all federal agencies, except for direct costs with EPA, for the following compliance requirements in the OMB *Compliance Supplement* as they related to the research and development cluster major program:

   - Activities Allowed or Unallowed
   - Allowable Cost/Cost Principles
   - Period of Availability of Federal Funds/Period of Performance

7. DCAA tested the internal control over compliance with respect to the above listed compliance requirements described as DCAA's responsibility as they related to the federal awards of the research and development cluster major program.

For the BDO responsibilities described above, we have audited the Company's compliance with the types of compliance requirements described in the OMB *Compliance Supplement* that could have a direct and material effect on the Company's major federal program for the year ended September 30, 2018. The Company's major federal program is identified in the summary of auditor's results section of the accompanying schedule of findings and questioned costs.

Management's Responsibility

Management is responsible for compliance with federal statutes, regulations, and the terms and conditions of its federal awards applicable to its federal programs.

Auditor's Responsibility

Our responsibility is to express an opinion on compliance for the Company's major federal program based on our audit of the types of compliance requirements referred to above as BDO's responsibility. 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 the audit requirements of Title 2 U.S. Code of Federal Regulations Part 200, *Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards* (Uniform Guidance). Those standards and the Uniform Guidance 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 were the responsibility of BDO, that could have a direct and material effect on a major federal program occurred. An audit includes examining, on a test basis, evidence about the Company'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 on compliance for the major federal program with the compliance requirements which were the responsibility of BDO. However, our audit does not provide a legal determination of the Company's compliance.

Opinion on the Major Federal Program

In our opinion, the Company complied, in all material respects, with the types of compliance requirements which were the responsibility of BDO, referred to above that could have a direct and material effect on the major federal program for the year ended September 30, 2018.

Other Matters

The results of our auditing procedures disclosed an instance of noncompliance, which is required to be reported in accordance with the Uniform Guidance and which is described in the accompanying schedule of findings and questioned costs as item 2018-006. Our opinion on each major federal program is not modified with respect to this matter.

The Company's response to the noncompliance finding identified in our audit is described in the accompanying schedule of findings and questioned costs. The Company's response was not subjected to the auditing procedures applied in the audit of compliance and, accordingly, we express no opinion on the response.

Report on Internal Control Over Compliance

Management of the Company is responsible for establishing and maintaining effective internal control over compliance with the types of compliance requirements referred to above under BDO's responsibility. In planning and performing our audit of compliance, we considered the Company's internal control over compliance with the types of requirements that could have a direct and material effect on each major federal program to determine the auditing procedures that are appropriate in the circumstances for the purpose of expressing an opinion on compliance with the compliance requirements, which were the responsibility of BDO, for each major federal program and to test and report on internal control over compliance in accordance with the Uniform Guidance, 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 the Company'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 federal 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 federal program will not be prevented, or detected and corrected, on a timely basis*. A significant deficiency in internal control over compliance* is a deficiency, or a combination of deficiencies, in internal control over compliance with a type of compliance requirement of a federal program that is less severe than a material weakness in internal control over compliance, yet important enough to merit attention by those charged with governance.

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 material weaknesses or significant deficiencies. We did not identify any deficiencies in internal control over compliance that we consider to be material weaknesses. However, we did identify a certain deficiency in internal control over compliance, described in the accompanying schedule of findings and questioned costs as item 2018-006, that we consider to be a significant deficiency.

The Company's response to the internal control over compliance finding identified in our audit is described in the accompanying schedule of findings and questioned costs. The Company's response was not subjected to the auditing procedures applied in the audit of compliance and, accordingly, we express no opinion on the response.

The purpose of this report on internal control over compliance is solely to describe the scope of our testing of internal control over compliance and the results of that testing based on the requirements of the Uniform Guidance. Accordingly, this report is not suitable for any other purpose.

BDO USA, LLP

McLean, Virginia
June 26, 2019

Section I - Summary of Auditor's Results

Consolidated Financial Statements

Type of auditor's report issued on whether the consolidated financial statements audited were prepared in accordance with U.S. GAAP:	Unmodified	
Internal control over financial reporting:		
• Material weakness(es) identified?	____ Yes	X No
• Significant deficiency(ies) identified?	____ Yes	X None reported
• Noncompliance material to consolidated financial statements noted?	____ Yes	X No

Federal Awards

Internal control over the major program:		
• Material weakness(es) identified?	____ Yes	X No
• Significant deficiency(ies) identified?	X Yes	____ None reported
Type of auditor's report issued on compliance for the major program:	Unmodified	
Any audit findings disclosed that are required to be reported in accordance with 2 CFR 200.516(a)?	X Yes	____ No

Identification of the major federal program:

CFDA/Number	Name of Federal Program or Cluster
Various	Research and Development Cluster

Dollar threshold used to distinguish between Type A and Type B programs:	$3,000,000	
Auditee qualified as low-risk auditee?	X Yes	____ No

Section II – Financial Statement Findings

There were no findings related to the consolidated financial statements which are required to be reported in accordance with generally accepted government auditing standards (GAGAS) identified during the 2018 audit.

Section III – Federal Award Findings and Questioned Costs

2018-006 - Reporting

Information on Federal Program:

Research and Development Cluster
U.S. Department of Defense
Direct program with the Department of the Air Force
CFDA Number: 12.RD
Award Number: GS-00F-0019L

Criteria:

2 CFR Ch. II § 200.327 *Financial Reporting*

Unless otherwise approved by OMB, the Federal awarding agency may solicit only the standard, OMB-approved government-wide data elements for collection of financial information (at time of publication the Federal Financial Report or such future collections as may be approved by OMB and listed on the OMB Web site). This information must be collected with the frequency required by the terms and conditions of the Federal award, but no less frequently than annually nor more frequently than quarterly except in unusual circumstances, for example where more frequent reporting is necessary for the effective monitoring of the Federal award or could significantly affect program outcomes, and preferably in coordination with performance reporting.

2 CFR Ch. II § 200.328 *Monitoring and Reporting Program Performance*

The non-Federal entity is responsible for oversight of the operations of the Federal award supported activities. The non-Federal entity must monitor its activities under Federal awards to assure compliance with applicable Federal requirements and performance expectations are being achieved. Monitoring by the non-Federal entity must cover each program, function or activity.

The Federal awarding agency must use standard, OMB-approved data elements for collection of performance information (including performance progress reports, research performance progress reports, or such future collections as may be approved by OMB and listed on the OMB Web site).

The non-Federal entity must submit performance reports at the interval required by the Federal awarding agency or pass-through entity to best inform improvements in program outcomes and productivity. Intervals must be no less frequent than annually nor more frequent than quarterly except in unusual circumstances, for example where more frequent reporting is necessary for the effective monitoring of the Federal award or could significantly affect program outcomes. Annual reports must be due 90 calendar days after the reporting period; quarterly or semiannual reports must be due 30 calendar days after the reporting period. Alternatively, the Federal awarding agency or pass-through entity may require annual reports before the anniversary dates of multiple year

Federal awards. The final performance report will be due 90 calendar days after the period of performance end date. If a justified request is submitted by a non-Federal entity, the Federal agency may extend the due date for any performance report.

Condition: During BDO's testing of reporting requirements for all non-classified federal awards of the research and development cluster major federal program, BDO noted that one of the sixty monthly reports examined had no evidence of being prepared and submitted in a timely manner in accordance with the terms of the award.

Cause: For the one report tested for which no evidence could be provided to show timely preparation and submission, the individual who would ordinarily submit the report was out of the office for an extended period of time. The secondary individual who submitted the report at the time is subsequently no longer with the Company, and thus unable to provide any evidence that the report was submitted at the original due date. If the report was submitted timely, no documentation was shared with other individuals with responsibilities for financial reporting under this award.

Effect: Failure to properly track all reporting requirements resulted in management not maintaining evidence of this report's submission before the prescribed due date. This could ultimately lead to noncompliance with the terms of the federal award.

Questioned Costs: None.

Context: This is a condition identified during BDO's testing over the reporting requirements for all non-classified federal awards of the research and development cluster major federal program. A total of sixty monthly reports were examined from the total population of contracts with reporting requirements. A total of 1 report out of sixty examined was determined to have been delivered late.

Identification as a Repeat Finding: The financial reporting finding is a repeat finding from 2017. Refer to finding 2017-011 in the separately issued summary schedule of prior audit findings.

Recommendation: We recommend that SRC improve their controls over the preparation and delivery of financial reports. Required reports should be prepared and delivered to each grantor within the contractual time frame unless exempted by a contract clause. Additionally, we recommend that a supervisor review all reports for accuracy prior to submission, for which the review performed should be documented, as well as maintain evidence of when all reports are submitted. This evidence should be part of a monthly close process, where several individuals can access the documentation and records.

Views of Responsible Officials: SRC agrees that the report in question was submitted late. As stated by BDO, this late submittal was a result of one manager on an extended leave. SRC will discuss with the applicable manager to ensure they properly delegate report submittals if out of the office in the future. We believe this to be an isolated issue, as over the last several years SRC has reviewed all processes and procedures, made updates when needed, and has educated employees to ensure adequate procedures are in place that would require compliance with the financial reporting requirements. SRC believes that evidence is already available to show when reports are submitted and provided that evidence during the audit.

Contact Person Responsible for Corrective Action: Danielle Chabot, Director, Compliance
Completion Date: Education of applicable employees on this finding will be completed by September 30, 2019

SRC, Inc.
Management's Views and Corrective Action Plan Regarding Uniform Guidance Audit Findings for the Year ending September 30, 2018

Finding 2018-006

SRC agrees that the report in question was submitted late. As stated by BDO, this late submittal was a result of one manager on an extended leave. SRC will discuss with the applicable manager to ensure they properly delegate report submittals if out of the office in the future. We believe this to be an isolated issue as over the last several years SRC has reviewed our processes and procedures, made updates when needed, and has educated employees to ensure adequate procedures are in place that would require compliance with the financial reporting requirements. SRC does believe that evidence is already available to show when reports are submitted and provided that evidence during the audit.

Contact Person Responsible for Corrective Action: Danielle Chabot, Director, Compliance
Completion Date: Education of applicable employees on this finding will be completed by September 30, 2019

SRC, Inc.
Uniform Guidance Audit Report: Summary Schedule of Prior Audit Findings

Year Ending September 30, 2017

Finding 2017-011
Summary of Prior Audit Finding:
Financial Reporting Research and Development Cluster

Recommendation:
E&Y recommended that SRC improve their controls over the preparation and delivery of financial reports. Required reports should be prepared and delivered to each grantor within the contractual time frame unless exempted by a contract clause. Additionally, they recommended that a supervisor review all reports for accuracy prior to submission, and the review should be documented.

Status of Finding:
SRC understood EYs position, however SRC respectfully disagreed with their assertion that the reports were not sent on time due to oversight by the responsible preparers and inadequate review. Over the last several years, SRC has reviewed processes and procedures, making updates as needed, and currently believes that there are already adequate procedures in place that would require compliance with the financial reporting requirements. SRC agreed that the reports in question were late (between two to seven days late); however, SRC feels that the delay in reporting was minimal and was done because of its efforts to increase oversight over financial reporting to ensure the data submitted to its customers is accurate and reviewed appropriately. In addition, SRC believes the two inaccuracies mentioned (.5 hours and 1 hour) to be extremely minor and does not believe them to impede SRC’s customers’ ability to determine progress on the contracts in question.

As corrective action, SRC has continued to educate applicable employees on the requirements as well as continued to attempt the negotiation of additional time for financial reporting in its contracts.

Section

2

DEFENSE CONTRACT AUDIT AGENCY

Audit Report No. 3441-2018M10110001

Upstate New York Branch Office
375 Saratoga Road, Suite 1
Glenville, NY 12302

June 14, 2019

Independent Audit Report on SRC, Inc.'s Compliance with Requirements Applicable to its Major Program and on Internal Control Over Compliance in Accordance with the Uniform Guidance at 2 CFR Part 200 for Fiscal Year Ended September 30, 2018

SPECIAL WARNING: The contents of this audit report must not be released or disclosed, other than to those persons whose official duties require access in accordance with Department of Defense (DoD) regulations. This document may contain information exempt from mandatory disclosure under the Freedom of Information Act. Unauthorized disclosure of proprietary, contractor bid or proposal or source selection information may violate Title 18 United States Code (U.S.C.) § 1905 and/or Title 41 U.S.C. § 2102. Please see the Audit Report Distribution and Restrictions section of this report for further restrictions.

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CONTENTS

EXECUTIVE SUMMARY

ABOUT SRC, INC. (SRC)

SRC (CAGE Code 28541) is a not-for-profit research and development firm chartered by the State of New York. SRC specializes in Research and Development for the Federal Government. SRC is headquartered at 7502 Round Pound Road in Syracuse, NY. SRC also has sites in Aberdeen, MD; Arlington, VA; Chantilly, VA; Charlottesville, VA; Dayton, OH; Rome, NY; San Antonio, TX; and several support locations throughout the country. SRC had sales of $239 million for fiscal year ended (FYE) September 30, 2018. SRC's fiscal year (FY) 2018 sales are 98 percent related to the Federal Government and, the government sales are predominately flexibly priced. SRC has approximately 1,128 employees (SRC 895 and SRC Home Office 233). In FY 2018, the primary customers consisted of the US Air Force and US Army, which represented approximately 59 percent of the total claimed costs.

SRC's Federal awards fall under the designation of a Research and Development (R&D) Cluster. Federal programs with different Catalog of Federal Domestic Assistance (CFDA) numbers that are closely related programs that share common compliance requirements are defined as a cluster of programs. Since all of SRC's Federal awards fall under the R&D cluster, SRC is considered to only have one major Federal program (R&D).

ABOUT THIS AUDIT

In accordance with Code of Federal Regulations, Title 2, Part 200 (2 CFR 200), the U.S. Defense Contract Audit Agency (DCAA) and BDO USA, LLP (BDO) performed a coordinated audit of SRC's R&D cluster. DCAA's audit responsibility included testing SRC's compliance with the following compliance requirements included in the Office of Management and Budget (OMB) 2018 Compliance Supplement: activities allowed or unallowed; allowable costs/cost principles; and period of performance. The Other Government, National Security Agency (NSA), and National Reconnaissance Organization (NRO) awards were audited for compliance with the following additional requirements: procurement and suspension and debarment; reporting; sub-recipient monitoring; and special tests and provisions. Our work included auditing SRC's proposed direct and indirect amounts for reimbursement on federal awards contained in its FY 2018 final indirect rate proposal, certified on March 1, 2019.

In addition, we tested SRC's internal controls structure with respect to the seven compliance requirements listed above as they related to SRC's R&D Cluster. Our audit of the R&D cluster did not include Environmental Protection Agency (EPA) awards included in the Schedule of Expenditures of Federal Awards, as the Independent Public Accountant (IPA) is responsible for these awards (See Appendix 4, page 31).

WHAT WE FOUND

Our examination of the auditee's internal controls and claimed costs for fiscal year ended (FYE) September 30, 2018, disclosed the following questioned indirect costs and issues with internal control over compliance:

A. Indirect Costs

- We questioned $163,130 of the home office allocation in the G&A pool and $138,868 in the Material Handling/Subcontracting pool in accordance with 48 CFR 9904.403 Allocation of Home Office Expenses to Segments, and FAR 31.201-2(a) Determining Allowability.

B. Internal Control Over Compliance

- We found the auditee to be in noncompliance with CAS 409, Depreciation of Tangible Capital Assets, which is related to claimed depreciation and the calculation of useful service lives. The auditee was not able to provide sufficient records that the useful periods of use are consistent with the actual periods of use. In addition, the auditee was unable to confirm whether the fully depreciated assets included in their books and records still existed or had been disposed of.
- We found the auditee to be in noncompliance with Period of Performance Compliance Requirement, as obligations are not liquidated within 90 calendar days after the end date of the period of performance.
- We determined that the auditee is not following its policies and procedures related to cost and price analyses used to negotiate and determine the reasonableness of their subcontract costs.
- We determined that the internal controls require strengthening to ensure incentive compensation costs are allocated based on the relative benefit received.

REPORT ON COMPLIANCE FOR EACH MAJOR FEDERAL PROGRAM

We have audited the SRC's compliance with the compliance requirements described in the 2 CFR 200, Appendix XI, Compliance Supplement (*OMB Compliance Supplement)* that could have a direct and material effect on each of SRC's major Federal programs for the year ended September 30, 2018. SRC's major Federal programs are identified in the summary of auditor's results section of the accompanying schedule of findings and questioned costs.

We have audited SRC's compliance with three of the compliance requirements described in the *OMB Compliance Supplement* that could have a direct and material effect on SRC's R&D program for the year ended September 30, 2018. The compliance requirements audited by DCAA are as follows, excluding EPA:

- Part A. Activities Allowed or Unallowed;
- Part B. Allowable Cost/Cost Principles; and
- Part H. Period of Performance.

In addition, the Other Government, NSA, and NRO awards were audited for compliance with the requirements of:

- Part I. Procurement, Suspension, and Debarment;
- Part L. Reporting;
- Part M. Subrecipient Monitoring; and
- Part N. Special Tests and Provisions.

SRC's independent public accounting (IPA) firm of BDO is responsible for reviewing compliance with Part C. Cash Management for all federal awards and with the following compliance requirements for the R&D Cluster excluding Other Government, NSA, and NRO awards:

- Part F. Equipment and Real Property Management;
- Part G. Matching, Level of Effort, Earmarking;
- Part I. Procurement and Suspension and Debarment;
- Part L. Reporting;
- Part M. Subrecipient Monitoring; and
- Part N. Special Tests and Provisions.

In addition, the IPA is responsible for reviewing SRC's compliance with Part A. Activities Allowed or Unallowable; Part B. Allowable Cost/Cost Principle; and Part H. Period of Performance for EPA awards.

The following compliance requirements were determined not applicable to SRC:

- Part E. Eligibility; and
- Part J. Program Income.

In addition, the following compliance requirements were determined not applicable to Other Government, NSA, and NRO Awards for the year ended September 30, 2018:

- Part F. Equipment and Real Property Management; and
- Part G. Matching, Level of Effort, Earmarking.

We also audited SRC's direct and indirect amounts for contract reimbursement on unsettled flexibly priced contracts contained in its FY 2018 final indirect rate proposal, submitted on March 1, 2019, to determine if the proposed amounts comply with the terms of federal awards pertaining to accumulating and billing incurred amounts. The proposed final rates apply to the federal awards listed in Attachment 3, page 34. A copy of SRC's Certificate of Final Indirect Costs, dated March 1, 2019, is included as Appendix 1 to the report (see page 28).

Management's Responsibility

SRC's management is responsible for compliance with federal statutes, regulations, and the terms and conditions of its federal awards applicable to its federal programs, including the design, implementation, maintenance of internal control to prevent or detect and correct noncompliance due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on compliance for each of SRC's major federal programs based on our audit of the types of compliance requirements referred to above. 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 the audit requirements of Title 2 U.S. *Code of Federal Regulations* Part 200, *Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards* (Uniform Guidance). Those standards and the Uniform Guidance 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 federal program occurred. An audit includes examining, on a test basis, evidence about SRC's compliance with those requirements and performing such other procedures, as we considered necessary in the circumstances. The nature, timing, and extent of the procedures selected depend on our professional judgment, including an assessment of risks of material noncompliance, whether due to fraud or error, and involve examining evidence about the proposed amounts.

We believe that the evidence we obtained is sufficient and appropriate to ensure that our audit provides a reasonable basis for our audit opinion on compliance for the major federal program. However, our audit does not provide a legal determination on SRC's compliance.

Unmodified Opinion on SRC's Compliance with the R&D Cluster

In our opinion, SRC complied, in all material respects, with the types of compliance requirements referred to above that could have a direct and material effect on each of its major federal programs for the year ended September 30, 2018. SRC's proposed amounts on unsettled flexibly priced contracts comply, in all material respects, with contract terms pertaining to accumulating and billing incurred amounts.

Other Matters

The results of our auditing procedures disclosed instances of noncompliance that are required to be reported in accordance with the Uniform Guidance and, which are described in the accompanying schedule of findings and questioned costs as item 2018-001, Exhibit, page 12. Our opinion on each major federal program is not modified with respect to these matters.

SRC's response to the noncompliance findings identified in our audit are described in the accompanying Corrective Action Plan for the Current Year, Appendix 3, page 30. SRC's response was not subjected to the auditing procedures applied in the audit of compliance and, accordingly, we express no opinion on the response.

The Summary Schedule of Claimed Expenditures by Federal Sponsor is found in Appendix 4, page 31. It does not represent the final costs by Federal sponsor, as it does not incorporate our questioned indirect costs.

The audit results and recommendations related to the indirect rates are summarized in Attachment 1, page 32, and presented in detail in the accompanying Schedule of Findings and Questioned Costs, Exhibit, page 12. The detailed final audit determined indirect rates, allocation bases, and applicable government participation in these bases are included as Attachment 2, page 33, of this report. These indirect rates were agreed to in the Indirect Cost Rate Agreement signed June 11, 2019 and documents the auditee's concurrence with our findings and recommendation.

REPORT ON INTERNAL CONTROL OVER COMPLIANCE

Management of SRC is responsible for establishing and maintaining effective internal control over compliance with the types of compliance requirements referred to above. In planning and performing our audit of compliance, we considered SRC's internal control over compliance with seven of the types of requirements that could have a direct and material effect on each major federal program to determine the auditing procedures that are appropriate in the circumstances for the purpose of expressing an opinion on compliance for each major federal program and to test and report on internal control over compliance in accordance with the Uniform Guidance, 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 SRC'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 federal 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 federal program will not be prevented, or detected and corrected, on a timely basis. A *significant deficiency in internal control over compliance* is a deficiency, or a combination of deficiencies, in internal control over compliance with a type of compliance requirement for a federal program that is less severe than a material weakness in internal control over compliance, yet important enough to merit attention by those charged with governance.

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 material weaknesses or significant deficiencies and therefore, material weaknesses or significant deficiencies may exist that have not been identified. We did not identify any deficiencies in internal control over compliance that we consider to be material weaknesses. However, we identified certain deficiencies in internal control over compliance, as described in the accompanying schedule of findings and questioned costs, Exhibit, page 12, as items 2018-002, 2018-003, 2018-004, and 2018-005, that we consider to be significant deficiencies.

SRC's response to the internal control over compliance findings identified in our audit is described in the accompanying Schedule of Findings and Questioned Costs (Exhibit, page 12) as well as SRC's Corrective Action Plan for the Current Year (Appendix 3, Page 30). SRC's response was not subjected to auditing procedures applied in the audit of compliance and, accordingly, we express no opinion on the response.

The purpose of this report on internal control over compliance is solely to describe the scope of our testing of internal control over compliance and the results of that testing based on the requirements of Uniform Guidance. Accordingly, this report is not suitable for any other purpose.

AUDITOR'S COMMENTS ON SUMMARY SCHEDULE OF PRIOR AUDIT FINDINGS

As part of our audit, we included procedures to assess the reasonableness of SRC's Summary Schedule of Prior Audit Findings, included as Appendix 2, page 29. Our audit disclosed that SRC's corrective action was taken regarding audit finding numbers 2017-001, 2017-002, 2017-003, 2017-005, 2017-006, 2017-009, and 2017-010. We followed up on SRC's corrective action in these areas and did not identify any exceptions. Therefore, audit finding numbers 2017-001, 2017-002, 2017-003, 2017-005, 2017-006, 2017-009, and 2017-010 are no longer open.

Our audit disclosed that SRC's corrective action taken regarding audit finding number 2017-008 included updated applicable policies and procedures to document the process for monitoring the timely submission of vouchers by subcontractors. SRC did not make this change until FY 2019; therefore, we could not follow up on the corrective action in this area. As a result, audit-finding number 2017-008 remains open.

Our audit disclosed that SRC's corrective action taken regarding audit finding number 2017-007 included updating its current process to ensure delegation of authority is clearly defined by revising language in the buyer's checklist. During our current audit, we followed up on the corrective action as part of the direct material and subcontracts testing and took no exception. However, we also performed testing related to inter-organizational transfers (IOTs), which do not require buyer's checklists. As a result, proper documentation of delegation of authority was not obtained, and the corrective action does not adequately correct the finding. Therefore, we believe that further corrective action is required related to documentation of delegation of authority, as it relates to IOTs and audit finding 2017-007 will remain open.

Our audit disclosed that SRC's corrective action taken regarding audit finding number 2017-004 included written approvals for new participants, incentive goals, and payments, ensuring requirements for review of goals is consistent with actual practices and ensuring all applicable entities are appropriately sharing in the incentive compensation costs. SRC did not make changes related to written approvals for new participants and incentive goals until FY 2019; therefore, we could not follow up on the corrective action in this area. As a result, audit-finding number 2017-008 as it relates to written approvals for new participants and incentive goals remains open. SRC's corrective action related to written approval of payments was tested and found to be adequate. During our testing, we confirmed that SRC specifically made a year-end adjustment to reclassify incentive compensation costs to unallowable for those costs applicable to related entities. However, our evaluation of this adjustment determined that SRC did not take into consideration several factors. Therefore, we believe that further corrective action is required related to the incentive compensation; consequently, this item remains open, and we have included this finding in number 2018-005 in the Schedule of Findings and Questioned Costs, Exhibit.

EXIT CONFERENCE

We provided a draft copy of the report and discussed the results of our examination with Ms. Danielle Chabot, Director of Compliance, and Ms. Tasha Haynes, Compliance Manager, in an exit conference held on May 29, 2019. SRC concurred with findings numbers 2018-001, 2018-002 and 2018-005 and did not concur with finding numbers 2018-003 and 2018-004. The complete text of the auditee's response appears as Appendix 3. SRC's response and corrective action plan were not subjected to the auditing procedures applied in the audit of compliance and, accordingly, we express no opinion on the response or the corrective action plan.

We are available to discuss the results of audit and participate in negotiations at your convenience.

DCAA PERSONNEL

	Telephone No.
Primary contacts regarding this audit:	
Coleen A. Ervin, Senior Auditor	571-448-3940
Caitlin Haigney, Senior Auditor	571-448-3949
Tracy LaMoy, Senior Auditor	571-448-5031
Kulwinder Kaur, Senior Auditor	571-448-5982
Antonietta Clemente, Supervisory Auditor	571-448-3951
Other contact regarding this audit report:	
John H. Burns, Branch Manager	571-448-3929
	FAX No.
Upstate New York Branch Office	518-399-3969
	E-mail Address
Upstate New York Branch Office	dcaa-fao3441@dcaa.mil

General information on audit matters is available at http://www.dcaa.mil/.

AUDIT REPORT AUTHORIZED BY:

John H. Burns

Digitally signed by BURNS.JOHN.H.1228557559
Date: 2019.06.14 11:56:37 -04'00'

John H. Burns
Branch Manager
DCAA Upstate New York Branch Office

AUDIT REPORT DISTRIBUTION

	E-mail Address
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Restrictions

1. The For Official Use Only (FOUO) marking placed on this audit report is not a security marking. It is a marking required by DoD Freedom of Information Act (FOIA) regulations. The marking provides notice that the report might contain information that is subject to withholding under the FOIA. The FOUO marking is a notice limited to Department of Defense employees.

2. The Defense Contract Audit Agency has no objection to the auditee releasing this report, at their discretion for public inspection. DCAA also has no objection to the auditee excluding Attachments of this report from the filing with the Federal Clearinghouse due to the proprietary nature of the information included in attachments.

3. This report is intended solely for the information and use by Federal awarding agencies and pass-through entities and is not intended to be, and should not be, used by anyone other than these specified parties.

SCHEDULE OF FINDINGS AND QUESTIONED COSTS
SRC, Inc.
Fiscal Year Ended September 30, 2018

SECTION I: -- SUMMARY OF AUDITOR'S RESULTS:

A. Financial Statements:

Information pertaining to the financial statements and the report on the Schedule of Expenditures of Federal Awards required by the Uniform Guidance are included in the independent public accountant's audit report.

B. Federal Awards:

Type of auditor's report issued on compliance for major programs:

Type of Audit Opinion	Research & Development Cluster
Unmodified	X
Qualified	
Adverse	
Disclaimer	

Internal control over major programs:

	Yes	None Reported
Material weaknesses were identified.		X
Significant deficiencies identified not considered to be material weaknesses.	X	

Audit findings disclosed that are required to be reported in accordance with 2 CFR 200.516(a)

Yes	X
No	

Identification of Major Programs:

CFDA Number	Federal Program
N/A	Research & Development Cluster

Dollar threshold used to distinguish between Type A and Type B programs:

$3,000,000

Auditee classified as a low-risk under 2 CFR 200 Subpart F:

Yes	X
No	

SCHEDULE OF FINDINGS AND QUESTIONED COSTS

SRC, Inc.
Fiscal Year Ended September 30, 2018

SECTION II: -- FINDINGS RELATED TO FINANCIAL STATEMENTS:

Information pertaining to the financial statements can be found in the independent public accountant's audit report.

SECTION III: FINDINGS RELATED TO FEDERAL AWARDS:

A. INDIRECT COSTS

G&A

		Questioned Costs		
Account	**Claimed**	**Total**	**Concurred**	**Note**
Home Office Allocation	$18,302,603	$163,130	$163,130	2018-001
Service Center Allocation Expense	$517,903	$0		
All Other Costs	$2,024,668	$0		
Total Pool	$20,845,174	$163,130	$163,130	

Material Handling/Subcontracting

		Questioned Costs		
Account	**Claimed**	**Total**	**Concurred**	**Note**
Home Office Allocation	$1,943,057	$138,868	$138,868	2018-001
Service Center Allocation Expense	$175,087	$0		
All Other Costs	$167,123	$0		
Total Material Handling Pool	$2,285,267	$138,868	$138,868	

2018-001 Home Office Allocations

a. Condition:

We questioned $163,130 of the home office allocation in the G&A pool and $138,868 in the Material Handling/Subcontracting pool, as reported in Audit Report No. 3441 2018M10100002, dated June 10, 2019.

SRC G&A pool expenses include allocations of shared costs from ten home office pools. The labor and associated fringe and other expenses that benefit more than one segment are accumulated as shared and allocated in accordance with the auditee's disclosed practices. Our review of the home office pools noted the following reclassifications in accordance with 48 CFR 9904.403-40(a)(1) Allocation of Home Office Expenses to Segments, FAR 31.201-2(a)(2) and -2(a)(3) Determining Allowability:

- The entire amount of directly attributed Finance & Accounting labor was changed to a shared cost, as the auditee could not substantiate any of the labor charges as allocable to a specific entity.
- Labor costs from the Human Resources pool directly attributed to SRC were changed to a shared cost as these costs benefitted other entities besides just SRC.
- Labor costs from the Computer Center pool directly attributed to SRC were changed to shared costs as these costs benefitted other entities besides just SRC.
- Consultant costs from the Human Resources pool claimed as directly attributed to SRC were changed to a shared costs as these costs benefitted other entities besides just SRC.

In addition, we reclassified shared expenses of Corporate IT, Human Resources, and Corporate Communications pools based on questioned headcount in the allocation base values of these pools in accordance with FAR 31.201-3 Determining Reasonableness. Home office employees were included in the headcount allocation base total for the SRC segment, which is not equitable as home office employees are shared.

We incorporated and quantified the impact of 48 CFR 9904.403 noncompliances identified in Audit Report No. 3441-2019S19403001, to be issued June 2019, which identified allocation bases of home office expense pools which are not compliant in accordance with 48 CFR 9904.403-50(b)(1) and segments which received benefit from but no allocation from the home office. This is not compliant in accordance with 48 CFR 9904.403-50(a)(2). We quantified the impact by reallocating shared expenses of the impacted pools over alternate allocation bases, which included all appropriate benefitting segments. The net impact of the questioned pool costs and reallocating shared expenses over alternate allocation bases resulted in the questioned costs of $163,130.

SRC used an allocation base of directly attributed labor of the home office expense pool to allocate the shared costs in the Material Handling/Subcontracting pool. We examined the auditee's methods of allocating its home office expenses for compliance with CAS 403 in Audit Report No. 3441-2019S19403001, to be issued June 2019, and noted directly attributed labor as an allocation base is not compliant with 48 CFR 9904.403-50(b)(1). We quantified the impact of the noncompliance for the Material Handling/Subcontracting home office expenses by allocating the home office expenses over an alternate allocation method, which included direct material and subcontract dollars, IOTs, and inventory of the benefitting segments. The alternate allocation methods used here are for quantifying an impact of the CAS 403 noncompliances only. They do not represent DCAA recommended or suggested allocation bases. This resulted in the questioned costs of $138,868.

The questioned costs represent indirect costs that pertain to all Federal contracts under SRC's R&D programs.

We do not consider the $301,998 questioned amount to be subject to the penalty stated at FAR 42.709 and DFARS 231.7002.

b. Criteria:

We examined 48 CFR 9904.403-50(a)(2), which states:

> *"Where the expense of a given function is to be allocated by means of a particular allocation base, all segments shall be included in the base unless:*
> *(i) Any excluded segment did not receive significant benefits from, or contribute significantly to the cause of the expense to be allocated and,*
> *(ii) Any included segment did receive significant benefits from or contribute significantly to the cause of the expense in question."*

In addition, we examined 48 CFR 9904.403-50(b)(1), which states in part:

> *"The allocation of centralized service functions shall be governed by a hierarchy of preferable allocation techniques which represent beneficial or causal relationships. The preferred representation of such relationships is a measure of the activity of the organization performing the function. Supporting functions are usually labor-oriented, machine-oriented, or space-oriented."*

We evaluated the home office pool costs with the criteria of FAR 31.201-2(a), Determining Allowability, which states in part:

> *"A cost is allowable only when the cost complies with all of the following requirements:*
> *(1) Reasonableness.*
> *(2) Allocability.*
> *(3) Standards promulgated by the CAS Board, if applicable, otherwise, generally accepted accounting principles and practices appropriate to the circumstances.*
> *(4) Terms of the contract.*
> *(5) Any limitations set forth in this subpart."*

c. Recommendation:

The auditee should adjust the incurred cost submission to exclude the $163,130 from the G&A pool and $138,868 from the Material Handling/Subcontracting pool in accordance with 48 CFR 9904.403, FAR 31.201-2(a)(2), and FAR 31.201-2(a)(3).

d. SRC's Reaction:

SRC concurs to our findings. SRC's complete response is included in the Corrective Action Plan for the Current Year in Appendix 3, page 30.

B. INTERNAL CONTROL OVER COMPLIANCE

2018-002 Internal Control and Compliance Finding Related to CAS 409 Noncompliance

a. Condition:

Our review of compliance and internal control testing in accordance with *OMB* Compliance *Supplement* for Part A. Activities Allowed or Unallowed; Part B. Allowable Cost/Cost Principles; and Part H. Period of Performance identified an internal control deficiency related to claimed depreciation expenses and the calculation of service useful lives.

We performed a CAS 409, Depreciation of Tangible Capital Assets, audit under DCAA Audit Assignment number 3441-2018S19409001, dated January 15, 2019. During the audit, SRC was not able to provide sufficient records that the claimed useful asset lives are consistent with the actual periods of use. The auditee provided a list of fully depreciated assets, which are still included in their books and records. However, the auditee was unable to confirm whether the assets still existed or disposed of. As a result of our audit, we found the auditee to be in noncompliance with 48 CFR 9904.409-50(e)(1) and -50(e)(2), which requires the auditee to develop expected useful lives for tangible capital assets and maintain adequate records demonstrating that the expected useful periods of use are consistent with actual periods of use.

In response to the identified noncompliance, we judgmentally selected twenty Other Equipment assets (Asset Account 1-2-030-01-02), four Computer assets (Asset Account 1-2-030-01-01), and four Software assets (Asset Account 1-2-030-01-04) from the fully depreciated asset listing for further analysis. We requested information regarding the asset description, its location and whether it was still in use. The auditee was able to provide a description of the assets and whether it was still in use. However, the auditee was not able to provide documentation to support when assets were disposed of. In addition, when inquired further, the auditee stated that a number of the selected assets received upgrades or maintenance but was unable to provide documentation regarding what the upgrade/maintenance was, the cost of upgrades/maintenance, when the upgrade/maintenance occurred, and whether said costs were subsequently depreciated. The auditee stated that most of the information obtained was gathered through discussions with employees who are familiar with the history of the selected assets. It is our understanding that the exact length of actual period of use is not known.

The auditee has $33 million of fully depreciated assets still on their books but does not have the adequate documentation to support it. We believe the auditee has failed to monitor its assets and determine if the actual asset lives are consistent with the useful life. In addition, per the auditee's Fixed Asset Process Policy, accounting is to receive an e-mail from the appropriate personnel that a fixed asset is to be sold or disposed. Also, as noted in its Capital Asset Policy, the auditee has instituted a number of safeguards, such as periodic physical inventory to ensure all assets on the books are secure and in good working condition and the results will be reconciled to the books in a timely manner and all differences will be properly accounted for as dispositions. While such safeguards are in place, it does not appear that the auditee actually uses these practices. Since the auditee was unable to provide any documentation to support when items were dispositioned, combined with the fact that the disposed assets are still on SRC's books, we believe they are in noncompliance with their own policy and procedures related to disposition of assets.

Control activities are required to be implemented and performed to ensure assets are physically secured, periodically accounted for, and reconciled to recorded amounts. The auditee lacks effective control over monitoring, as there are not adequate procedures to ensure that assets included in the books and records physically exist and are still in use. Based on the information gathered, we are unable to determine the actual useful lives of these groups of assets and believe this issue is not limited to the groups selected. Without the appropriate documentation, it is unclear how the auditee can support the useful lives currently being used are reasonable. This noncompliance pertains to all Federal contracts under SRC's R&D program.

b. Criteria:

We examined SRC's Fixed Asset Process Policy, ACC-P-400, effective August 24, 2016, which states through the first step in the flow chart for the disposal or sale of a fixed asset:

> *"Accounting. Receive e-mail from appropriate personnel that Fixed Asset is to be sold or disposed."*

We also examined SRC's Capital Assets Policy, effective February 8, 2013, which states in part:

> *"Depreciation and Amortization.*
> *When it is apparent that the useful life of a capital asset is significantly different from the guidelines herein, the useful life will be adjusted as appropriate with approval by the Director of Accounting and Finance."*
>
> *"Dispositions.*
> - *Disposed assets will be removed from the books of the Company on a monthly basis.*
> - *Asset lives may be revised from time to time if disposition or capital asset physical inventory counts result in the awareness that actual lives are varying from the stated lives."*
>
> *"Safeguarding Capital Assets*
> *A capital asset physical inventor will be undertaken periodically to ensure that all assets as recorded on the books of the Company are secure and in good working condition. The results of the periodic physical inventory will be reconciled to the books of the Company in a timely manner and all differences will be properly accounted for as dispositions."*

In addition, we examined 48 CFR 4409.409-50(e)(1) and -50(e)(2), which states:

> *"(e) Estimated service lives initially established for tangible capital assets (or groups of assets) shall be reasonable approximations of their expected actual periods of usefulness, considering the factors mentioned in paragraph (a) of this subsection. The estimate of the expected actual periods of usefulness need not include the additional period tangible capital assets are retained for standby or incidental use where adequate records are maintained which reflect the withdrawal from active use.*
>
> > *(1) The expected actual periods of usefulness shall be those periods which are supported by records of either past retirement or, where available, withdrawal from active use (and retention for standby or incidental use) for like assets (or groups of assets) used in similar circumstances appropriately modified for specifically identified factors expected to influence future lives. The factors which can be used to modify past experience include:*
> >
> > > *(i) Changes in expected physical usefulness from that which has been experienced such as changes in the quantity and quality of expected output.*
> > >
> > > *(ii) Changes in expected economic usefulness, such as changes in expected technical or economic obsolescence of the asset (or group of assets), or of the product or service produced.*
> >
> > *(2) Supporting records shall be maintained which are adequate to show the age at retirement or, if the contractor so chooses, at withdrawal from active use (and retention for standby or incidental use) for a sample of assets for each significant category. Whether assets are accounted for individually or by groups, the basis for estimating service life shall be predicated on supporting records of experienced lives for either individual assets or any reasonable grouping of assets as long as that basis is consistently used. The burden shall be on the contractor to justify estimated service lives which are shorter than such experienced lives."*

c. Recommendation:

SRC should review its policies and procedures related to capital assets, dispositioning of assets, and record retention of those assets. We also recommend the auditee establish procedures to ensure that the useful life is periodically evaluated and update the useful lives, if necessary, to be in compliance with CAS 409. Furthermore, we recommend that the auditee train appropriate employees on the updated policies and procedures and ensure compliance with its updated policies and procedures.

d. SRC's Reaction:

SRC concurs to our findings. SRC's complete response is included in the Corrective Action Plan for the Current Year in Appendix 3, page 30.

2018-003 Internal Control and Compliance Finding Related to Period of Performance

a. Condition:

Our review of compliance and internal control testing in accordance with *OMB Compliance Supplement* for Part A. Activities Allowed or Unallowed; Part B. Allowable Cost/Cost Principles; and Part H Period of Performance noted noncompliance with the liquidation of payments.

We identified federal awards with performance periods ending during fiscal year 2018, and we tested a sample of transactions recorded during the latter part and after the period of performance to determine if costs were incurred within the period of performance and the liquidation occurred within the allowed time-period. Our evaluation noted no costs incurred after the period of performance. However, we noted the liquidation did not occur within the allowed time-period. Per the *OMB Compliance Supplement*, the liquidation must occur no later than 90 days after the end of the period of performance. We noted an exception with one subcontract payment under Project AS020.C8713.1703.B. The subcontract invoice was dated June 5, 2018, and not paid until September 7, 2018. Per SRC, "the delay in payment was caused by multiple modifications of the purchase order to conform with contract years not originally accounted for when the purchase order was issued." Project AS020.C8713.1703.B has a period of performance end date of May 21, 2018, and by the period of performance compliance requirement the liquidation of payments must occur within 90 days or August 18, 2018. The auditee did not respond in a timely manner to make the necessary modifications, which resulted in a late payment to the subcontractor. Therefore, the auditee is in noncompliance with the period of performance compliance requirement.

In addition, during our reconciliations of the auditee's incurred cost submission, we noted projects, which were marked as physically complete in FY 2017; however, there were costs in FY 2018. We were informed that the costs were credits to the IOTs accounts for intercompany subcontracts related to FY 2017 for Projects US005.01.02B and US005.01.01. Our review of the respective invoices noted the majority of the costs related to FY 2017 rate adjustments. According to SRC, these adjustment vouchers could not be completed until the related entity had audited rates. These projects had a period of performance end date of July 15, 2017, and by the period of performance compliance requirement the liquidation of payments must occur within 90 days or October 13, 2017. All of the credit adjustments occurred in July through September 2018, well after the period of performance end date. This is due to the fact the IOT did not revise its billing rates until after the completion of the audit of its final indirect rates. Therefore, the auditee is in noncompliance with this compliance requirement. This noncompliance pertains to all federal contracts under SRC's R&D program.

b. Criteria:

2 CFR Part 200, Part 3 Compliance Supplement dated April 2017 for Part H. Period of Performance states the following compliance requirements:

> *"A non-Federal entity may charge to the Federal award only allowable costs incurred during the period of performance and any costs incurred before the Federal awarding agency or pass-through entity made the Federal award that were authorized by the Federal awarding agency or pass-through entity (2 CFR section 200.309)."*
>
> *"Unless the Federal awarding agency or pass-through entity authorizes an extension, a non-Federal entities must liquidate all obligations incurred under the Federal award not later than 90 calendar days after the end of the date of the period of performance as specified in the terms and conditions of the Federal award (2 CFR section 200.343(b). When used in connection with a non-Federal entity's utilization of funds under a Federal award, "obligations" means orders placed for property and services, contracts and subawards made, and similar transactions during a given period that require payment by the non-Federal entity during the same or a future period (2 CFR section 200.71)."*

2 CFR Part 200, Appendix XI Compliance Supplement dated April 2018 for the requirements of Part A. Activities Allowed or Unallowed; Part B. Allowable Costs/Cost Principles; and Part H. Period of Performance requires us to plan and perform tests of internal control including: information and communication which requires the organization to provide accurate and complete information to appropriate individuals on a timely basis; and monitoring to assess the quality of performance over time and promptly resolve findings. We performed testing to determine if:

> *"Reconciliations and reviews ensure accuracy of reports."*
>
> *"There are established channels of communication between the pass-through entity and sub recipients."*
>
> *"Actions are taken as a result of communications received."*
>
> *"Ongoing monitoring is build-in through independent reconciliations, staff meetings, feedback, rotating staff, supervisory review and management review of reports."*

In addition, we evaluated the claimed costs with the criteria of FAR 31.201-2(d), which states:

"A contractor is responsible for accounting for costs appropriately and for maintaining records, including supporting documentation, adequate to demonstrate that costs claimed have been incurred, are allocable to the contract, and comply with applicable cost principles in this subpart and agency supplements. The contracting officer may disallow all or part of a claimed cost that is inadequately supported."

c. Recommendation:

The auditee should strengthen its internal controls to ensure contract costs are liquidated within 90 days after the period of performance. The auditee should evaluate, and revise as necessary, its process for monitoring purchase orders to ensure related invoices are processed for payment in a timely manner and within the required liquidation period. The auditee should evaluate, and revise as necessary, its process for monitoring IOTs to ensure that billing rates are adjusted during and at end of the fiscal year to ensure payment is within the required liquidation period.

d. SRC's Reaction:

SRC agrees to the noncompliance noted related to the one subcontract invoice not paid within 90 days. However, SRC does not agree that the period of performance compliance requirement as it related to indirect billing rates. SRC does not believe that billing rate adjustments meet the definition of an obligation. SRC's complete response is included in the Corrective Action Plan for the Current Year in Appendix 3, page 30.

e. Auditor's Response:

SRC states that indirect rate adjustments are not included in the definition of obligation and believe these costs do not become an "obligation" until they are finalized. We find that direct and indirect costs are part of "orders placed for property and services, contracts and subawards made" and the adjustment for the rates are therefore also included as they are for the costs incurred during the performance. We note the period of performance compliance requirement states *"Unless the Federal awarding agency or pass-through entity authorizes an extension, a non-Federal entities must liquidate all obligations..."* which indicates that if SRC is unable to liquidate their obligations within the 90 days an extension would be required related to the liquidation of obligations.

<u>2018-004 Internal Control and Compliance Finding Related to Documentation of Price Analyses</u>

a. Condition

Our review of compliance and internal control testing with Uniform Guidance Compliance Supplement requirements for Part A. Activities Allowed or Unallowed; Part B. Allowable Costs/Cost Principles; and Part H. Period of Performance noted an internal control deficiency relating to the auditee's documentation of price analysis and support for commercial items.

We judgmentally selected two subcontractors for testing. Part of our subcontract testing included obtaining price analyses and evaluating the subcontract file to determine whether the claimed subcontract costs are fair and reasonable. We examined SRC's price analysis related to engineering services provided by the first subcontractor, which we noted only consisted of SRC comparing its own labor rates to those proposed by the subcontractor. The analysis did not include any discussions related to the similarities/differences between the two companies nor was there any comparison to other potential suppliers of engineering services. Further review of the subcontract files identified a memorandum stating "commercial item determination for subcontractor software" signed by the subcontract administrator. We did not identify documentation from the ACO approving subcontractor data store software as a commercial item. As a result, SRC failed to obtain adequate support from the ACO in determining the software as a commercial item; in addition, SRC failed to follow its policies and procedures for commercial item determination and completing price analysis. The auditee provided invoices from this subcontractor in an effort to support the sale of the software to the general public. Instead, invoices support purchases of this software that could apply to any number of this subcontractor's software applications, of which it is also unclear whether these are commercial or not. We consider the auditee's lack of documentation to be in noncompliance with their policy and internal controls. The auditee lacks the appropriate documentation and analysis required to determine that costs are fair and reasonable.

We also evaluated the second subcontract file for SCAS2009, which identified the award as noncompetitive. Due to the noncompetitive nature of the subcontract, SRC's price analysis compared the proposed hourly rate for this subcontractor to SRC's hourly rate for the contract. We also evaluated the auditee's noncompetitive acquisition justification form, which requires a check mark when there is a single or "only known supplier." The form for SCAS2009 states that this supplier is experienced; however, it fails to explain how they are the only known supplier of this service. The subcontractor is a supplier of engineering services and thus we would expect there to be other competitors and yet SRC fails to document what about this procurement makes this subcontractor unique. We consider SRC's lack of documentation and inconsistent information for the same subcontract to be an internal control deficiency. In addition, the price analysis is considered inadequate as the auditee only compared a competitive vendor to itself, with no explanation as to how SRC and this subcontractor are comparable. We consider the auditee's lack of documentation to be in noncompliance with their policy and internal controls. The auditee lacks the appropriate documentation and analysis required to justify the sole source claim and a determination that the costs are fair and reasonable.

These internal control deficiencies pertains to all federal contracts under SRC's R&D program.

b. Criteria:

We evaluated the costs with the requirements of FAR 15.404-3(b) and FAR 31.201-2(a). FAR 15.404-3(b) states in part, "*The prime contractor or subcontractor shall* – (1) *conduct appropriate cost or price analyses to establish the reasonableness of proposed subcontract prices.*" FAR 31.201-2(a), Determining Allowability, states the following:

> "*A cost is allowable only when the cost complies with all of the following requirements:*
> *(1) Reasonableness.*
> *(2) Allocability.*
> *(3) Standards promulgated by the CAS Board...*
> *(4) Terms of the contract.*
> *(5) Any limitations set forth in this subpart.*"

We examined SRC's policy SPP 8.1, Identifying the Need for Cost or Pricing Data, effective April 10, 2017 and revised August 16, 2018, which states and includes in part:

> "*The buyer may apply the commercial item exception if they determined that the item meet the definition of commercial item in FAR 2.101 and have completed price analysis as outlined in SPP 3.2.*"

Additionally, FAR 15.403-1(c)(3)(i) requires ACO approval of a commercial item as stated in part at FAR 15.403-1(c)(3)(i)

> "*Any acquisition of an item that the contracting officer determines meets the commercial item definition in 2.101,...*"

In addition, FAR 6.302-1(a)(2) states the following:

> "*(i) Supplies or services may be considered to be available from only one source if the source has submitted an unsolicited research proposal that –*
>
> *(A) Demonstrates a unique and innovative concept (see definition at 2.101), or, demonstrates a unique capability of the source to provide the particular research services proposed;*
> *(B) Offers a concept or services not otherwise available to the Government; and,*
> *(C) Does not resemble the substance of a pending competitive acquisition. (See 10 U.S.C. 2304(d)(1)(A) and 41 U.S.C. 3304(b)(1).)*

> *(ii) Supplies may be deemed to be available only from the original source in the case of a follow-on contract for the continued development or production of a major system or highly specialized equipment, including major components thereof, when it is likely that award to any other source would result in—*
>
> *(A) Substantial duplication of cost to the Government that is not expected to be recovered through competition; or*
> *(B) Unacceptable delays in fulfilling the agency's requirements. (See 10 U.S.C. 2304(d)(1)(B) or 41 U.S.C. 3304(b)(2).)"*

c. Recommendation:

The auditee should comply with its policy and procedures as indicated in SPP 8.1 to ensure adequate price analyses and commercial item determination are in accordance with FAR 2.101 and supports the costs are fair and reasonable per FAR 31. The auditee should document and demonstrate noncompetitive suppliers for subcontract services. Noncompetitive evaluations should explain unique factors of supplier, such as determination that the item or service is only available from one source.

d. SRC's Reaction:

SRC agrees to the finding related to the price analysis and noncompetitive justifications. However, SRC does not agree with the finding related to the commercial item determination. SRC believes the commercial determination for its subcontractors is the responsibility of the "SRC Procurement Representative" and not the Government Contracting Officer based on its interpretation of FAR 15.403-1. SRC's complete response is included in the Corrective Action Plan for the Current Year in Appendix 3, page 30.

e. Auditor's Response:

We continue to recommend SRC obtain the required contracting officer commercial item determination in accordance with FAR 15.403-1(c)(3)(i). In addition, Contracting Officer is included in FAR 2.101 Definition, as follows:

> *"Contracting officer" means a person with the authority to enter into, administer, and/or terminate contracts and make related determinations and findings. The term includes certain authorized representatives of the contracting officer acting within the limits of their authority as delegated by the contracting officer. "Administrative contracting officer (ACO)" refers to a contracting officer who is administering contracts. "Termination contracting officer (TCO)" refers to a contracting officer who is settling terminated contracts. A single contracting officer may be responsible for duties in any or all of these areas."*

This covers Government contracting officers and not SRC representatives. This definition would be applicable to FAR 15.

2018-005 Internal Control and Compliance Finding Related to Incentive Compensation

a. Condition:

Our review of compliance and internal control testing in accordance with *OMB Compliance Supplement* for Part A. Activities Allowed or Unallowed and Part B. Allowable Cost/Cost Principles noted an internal control deficiency relating to allocation of incentive compensation.

We reviewed the incentive compensation, including long-term incentive compensation, for the top ten executives plus a judgmental selection of eight additional employees. We performed tests of SRC's internal control over compliance with requirements that could have a direct and material effect on a major federal program. Two of our objectives of test of controls were to determine if the costs are allowable and allocable to SRC.

We noted some financial goals are based on the performance of SRC and its related entities. SRC recorded multiple adjustments in FY 2018 to remove incentive compensation costs from claimed costs in the fringe pool. We noted the auditee specifically made a year-end adjustment to reclassify incentive compensation costs to unallowable costs applicable to related entities. However, our review of this adjustment noted SRC did not take the following items into consideration:

1. Consolidated and Corporate goals each had one goal based on revenue and a second goal based on earnings before interest and taxes. SRC only used revenue to calculate incentive compensation applicable to related entities. The earnings before interest and taxes percentage was significantly higher for SRCTec.

2. Divisional goals are based on Electronic Warfare (EW) and SRC International revenue; however, SRC made no adjustment as it was considered EW only.

3. SRC made no adjustment for SRCTec for home office employees as SRCTec got their share with the allocation of the labor and associated fringe. However, leaving these costs in the fringe pool results in increased fringe costs being allocated to both SRC and SRCTec and SRC bearing costs, which are applicable to SRCTec. The incentive compensation applicable to SRCTec should be removed from the SRC claimed costs.

4. SRC did not make any adjustment related to the customer goal based on International Revenue.

We determined incentive compensation costs in the amount of $31,404 should have not been included in the SRC fringe pool after the adjustment for costs applicable to related entities and application of the cost reimbursable percentage. Due to the significant base amount, the removal of these pool costs does not affect the fringe indirect rate. However, the internal controls require further strengthening to ensure costs are allocated based on the relative benefit received. This internal control deficiency pertains to all federal contracts under SRC's R&D program. This finding is a repeat finding from the prior period audit. Prior audit finding number is 2017-004.

b. Criteria:

2 CFR Part 200, Appendix XI Compliance Supplement dated April 2018 for the requirements of Part A. Activities Allowed or Unallowed and Part B. Allowable Costs/Cost Principles requires us to plan and perform tests of internal control including information and communication which requires the organization to provide accurate and complete information is provided to appropriate individuals on a timely basis. We performed testing to determine if:

> *"Accurate information is accessible to those who need it."*
>
> *"Reports are provided timely to managers for review and appropriate action."*
>
> *"Reconciliations and reviews ensure accuracy of reports."*

We evaluated the claimed costs with the criteria of FAR 31.201-4, Determining Allocability, which states the following:

> *"A cost is allocable if it is assignable or chargeable to one or more cost objectives on the basis of relative benefits received or other equitable relationship. Subject to the foregoing, a cost is allocable to a Government contract if it—*
>
> *(a) Is incurred specifically for the contract;*
> *(b) Benefits both the contract and other work, and can be distributed to them in reasonable proportion to the benefits received; or*
> *(c) Is necessary to the overall operation of the business, although a direct relationship to any particular cost objective cannot be shown."*

In addition, we evaluated the claimed costs with the criteria of FAR 31.201-2(a), which states in part:

"A cost is allowable only when the cost complies with all of the following requirements:

(1) Reasonableness.
(2) Allocability.
(3) Standards promulgated by the CAS Board, if applicable, otherwise, generally accepted accounting principles and practices appropriate to the circumstances.
(4) Terms of the contract.
(5) Any limitations set forth in this subpart."

c. Recommendation:

The auditee should evaluate its allocation of incentive compensation costs to ensure costs are allocated based on the relative benefit received and in compliance with the auditee's policies and procedures.

d. SRC's Reaction:

SRC concurs to our findings. SRC's complete response is included in the Corrective Action Plan for the Current Year in Appendix 3, page 30.

SRC, Inc.
Certificate of Final Indirect Costs

SRC, Inc.
Schedule N
Certificate of Final Indirect Costs
Fiscal Year Ended September 30, 2018

This is to certify that I have reviewed this proposal to establish final indirect cost rates and to the best of my knowledge and belief:

1 All costs included in this proposal dated March 1, 2019 to establish final indirect cost rates for Fiscal Year October 1, 2017 through September 30, 2018 are allowable in accordance with the cost principles of the Federal Acquisition Regulation (FAR) and its supplements applicable to the contracts to which the final indirect cost rates will apply; and

2 This proposal does not include any costs which are expressly unallowable under applicable cost principles of the FAR or its supplements

Firm: SRC Inc.

Signature: Philip Fazio

Name of Certifying Official **Philip Fazio**

Title **Executive Vice President, Finance & CFO**

Date of Execution 3/1/19

SUMMARY SCHEDULE OF PRIOR FINDINGS
SRC, Inc.
Fiscal Year Ended September 30, 2018

(5 Pages)

SRC, Inc.
Uniform Guidance Audit Report: Summary Schedule of Prior Audit Findings

Year Ending September 30, 2017

Finding 2017-001
Summary of Prior Audit Finding:
Severance Payments

Recommendation:
The auditee should adjust the incurred cost submission to exclude as unallowable $54,162 of severance pay and $24,520 of directly associated fringe as the costs are not reasonable. In addition, the auditee should review and adjust its policies and procedures to include procedures to search for like positions that the employee qualifies for prior to the RIF and severance payment and to adjust policies to ensure subsequent Reductions in Force consider the effect of potential subsequent rehire and its impact on severance payments.

Status of Finding:
Although SRC already has processes in place that would cover the areas outlined by DCAA (searching for like positions that employees qualify for prior to any reduction in force and for considering the effect of potential subsequent rehire and its impact on severance), we reviewed and updated our policies and procedures to ensure this process is appropriately documented. In addition, SRC adjusted the incurred cost submission to move the severance pay and associated fringe to unallowable.

Finding 2017-002
Summary of Prior Audit Finding:
Direct Material and Labor Costs Related to Period of Performance

Recommendation:
The auditee should adjust the incurred cost submission to exclude $61,783 of subcontract costs for AS020.C8713.1701.B as the costs were not incurred. In addition, the auditee should adjust the incurred cost submission to reclassify $11,037 of burdened cost for US005.01.01 to unallowable costs.

Status of Finding:
SRC agreed that the incurred cost submission should be updated and made the adjustment to exclude $61,783 of subcontract costs for AS020.C8713.1701.B. SRC also agreed that the $11,037 of burdened labor should be moved to unallowable on US005.01.01 and updated the incurred cost submission for this adjustment as well.

Finding 2017-003
Summary of Prior Audit Finding:
Direct Labor Costs

Recommendation:
The auditee should adjust the incurred cost submission to reclassify the direct labor costs to unallowable on project AY025.04 which will result in a refund to the customer of $41,355.

Status of Finding:
SRC agreed that the labor costs should be moved to unallowable and adjusted the incurred cost submission accordingly. In addition, we discussed the finding with the Project Manager to ensure she understood the requirements she would need to follow in the future.

Finding 2017-004
Summary of Prior Audit Finding:
Internal Control and Compliance Findings Related to Incentive Compensation

Recommendation:
The auditee should strengthen its internal controls to ensure approvals are adequately documented. The auditee should evaluate its review process to ensure the goals are met and the cost are allocated to all entities receiving benefit. The auditee should review and revise its incentive plans as necessary to ensure its practice is in compliance with written policies.

Status of Finding:
SRC management agreed that we need to strengthen our internal controls to ensure approvals are adequately documented. In order to achieve this, SRC reviewed our incentive compensation plans, as well as applicable policies and procedures and made necessary changes as a result of that review. Changes included requiring written approvals for new participants in the plan, written approval for any payments made as well as an update to our internal process to ensure the requirements for review of goals is consistent with our actual practice. Finally, SRC reviewed the allocation of incentive compensation to ensure all applicable entities are appropriately sharing in the costs.

Finding 2017-005
Summary of Prior Audit Finding:
Internal Control and Compliance Findings Related to Electronic Funds Transfers and Wire Transfers

Recommendation:
The auditee should comply with its policies and procedures with regards to approvals and signature requirements for financial transactions.

Status of Finding:
SRC agreed that that the approvals were not made in accordance with our signature authority matrix. SRC reviewed the signature authority requirements for financial transactions and updated the matrix accordingly.

Finding 2017-006
Summary of Prior Audit Finding:
Internal Control and Compliance Findings Related to Payroll Review and Approval

Recommendation:
The auditee should review its formal policies and procedures and include a formal, documented process for the review and approval of payroll registers assigned to Ceridian and maintaining evidence of their review and approval. A position above the Accounting Supervisor should, at a minimum, be formally reviewing and approving the payroll registers and reconciling the payroll registers to the general ledger on a routine basis. In addition, two approved signatories should be actively involved in the payroll payment process.

Status of Finding:
SRC agreed that we should review our policies and procedures for the payroll process and strengthen the documentation of the reviews being performed. SRC already reconciles our payroll registers to the general ledger monthly with quarterly reviews and will continue this process. A position above the Accounting Supervisor will now review and approve the payroll registers and documented approvals for payment will be required in accordance with our signature authority matrix.

Finding 2017-007
Summary of Prior Audit Finding:
Internal Control and Compliance Findings Related to Proper Execution of Purchase Orders

Recommendation:
The auditee should comply with its policies and procedures with regard to ensuring only approved employees (or those with appropriate delegations) execute approved purchase orders.

Status of Finding:
SRC enhanced its current process to ensure delegation of authority is clearly defined by revising the language included on the buyer's checklist. This update allows the subcontracts manager to delegate authority upon completing his review of the PO file.

Finding 2017-008
Summary of Prior Audit Finding:
Internal Control and Compliance Findings Related to Timely Submission of Subcontract Vouchers

Recommendation:
The auditee should develop adequate policies and procedures to document the process to be used to monitor the timely submission of adjustment vouchers by subcontracts to ensure that only allowable costs are included in billings and proposals to the auditee. Furthermore, the auditee should identify all open cost-type subcontracts and immediately contact those subcontractors to determine all necessary adjustments and make those adjustments.

Status of Finding:
SRC reviewed our policies and procedures and as a result made changes to document the process for monitoring the timely submission of vouchers by subcontractors. This new process was effective January 2019.

Finding 2017-009
Summary of Prior Audit Finding:
Internal Control and Compliance Findings Related to Direct Travel

Recommendation:
The auditee should comply with its policies and procedures with regard to claiming actual costs and EERs. We recommend employees, not administrative personnel, complete and submit their own EERs ensuring supporting documentation for the trip is submitted within a reasonable amount of time upon completion as required by SRC policy. Managers and Financial Analysts should be actively monitoring employees to ensure EER forms are completed timely. In addition, the auditee should review and revise its policies and procedures to institute stronger controls ensuring actual costs are claimed for travel expenses to comply with its disclosed practices.

Status of Finding:
SRC respectfully disagreed that our employees are not in compliance with our policy for recording actual travel expenses. The employees in question did, in fact, claim per diem on one or more days of their trips, however, the employees stated in writing that they only did so because their travel expenses exceeded the per diem and the employees did not wish to request reimbursement from the company. In this instance, SRC felt that the request of per diem was acceptable and advised the employees that, going forward, this occurrence should be documented on expense reimbursement forms to avoid any confusion.

SRC agreed that the EERs in question were submitted past the due date and have continued to educate applicable employees on policy requirements.

Finding 2017-010
Summary of Prior Audit Finding:
Internal Control and Compliance Findings Related to Training Database

Recommendation:
SRC should assess the effectiveness of their current approach to ensuring employee training compliance and develop a strategy to significantly reduce the number of employees who do not complete their training in a timely manner. We stress that the auditee should continue to periodically reevaluate the current methodology and develop effective means to hold employees accountable for completing required training in a timely manner. Furthermore, the auditee should stress the importance of completing training in a timely manner (i.e. by the required due date) and how the required trainings impact the performance of the employee's duties and subsequently compliance and regulatory requirements.

Status of Finding:
SRC reviewed the delinquencies noted by DCAA and respectfully disagreed with its assessment that our current process is ineffective, as we believe that our current compliance percentages are satisfactory (96% and 98% for the labor refresher, 97% for the new hire training and 96% for the safety training). As such, the vast majority of employees are completing their training within 90 days of the assignment, and we feel that employees are sufficiently trained on applicable policies and procedures in a timely manner. Even with a substantial influx of new employees, SRC's training completion results have not declined.

SRC management believes the organization has developed and implemented an effective process for completing required training in a timely manner and for holding employees accountable for training completions. Periodic reminders are sent to employees as training is rolled out, and when it becomes past due through our learning management system. Reports are created which notify employees of impending training due dates (in addition to the reminders already initiated by our leaning management system). Additionally, a monthly report is prepared by the compliance department, noting training that is past due which is shared with management, which, in turn, shares the report with employees. If training is not completed timely, employees can be impacted by a low rating in their compliance and ethics competency on their annual performance reviews which can impact the merit increase received by the employee. Finally, the auditee continuously stresses the importance of completing training a timely manner.

SRC, Inc.
CORRECTIVE ACTION PLAN FOR THE CURRENT YEAR

(2 Pages)

SRC Inc.
Management's Views and Corrective Action Plan Regarding Uniform Guidance Audit Findings for the Year Ending September 30, 2018

Finding 2018-001

SRC has made the adjustment as recommended by DCAA in our FY18 incurred cost submission.

Contact Person Responsible for Corrective Action: Danielle Chabot, Director, Compliance
Completion Date: The adjustment to the incurred cost submission has been completed.

Finding 2018-002

SRC agrees with the non-compliance and is reviewing current policies and procedures to ensure adequate records as required by 48 CFR 9904.409.50(e)(1) and -50(e)(2) exist to support the Company's estimated useful lives for tangible asset categories, as represented by the useful lives matrix. As part of this review, the Company will verify the existence of fully depreciated tangible assets that have not been withdrawn from use or disposed of in the accounting system. Once we have verified the existence of those assets, SRC will update its policies and procedures to incorporate the periodic analysis and reviews of our useful lives matrix to analyze if any adjustments are required. Additionally, SRC will educate relevant employees on the proper custody and record keeping of capital assets to ensure practice aligns with current policies and procedures in order to support the average age of retirement, or withdrawal from active use (and retention for standby or incidental use) for each asset class.

Contact Person Responsible for Corrective Action: Lisa Kennedy, Manager, Corporate Controller
Completion Date: SRC will complete our review of fully depreciated tangible assets by September 30, 2019. SRC will update its policies and procedures and educate all applicable employees by December 31, 2019.

Finding 2018-003

SRC partially agrees with the non-compliance as noted by DCAA. We agree that the one subcontract invoice in question was not paid within 90 days. As it relates to this portion of the finding, SRC will evaluate our processes and provide necessary training to all applicable employees.

However, we disagree with DCAA's interpretation of this period of performance compliance requirement as it relates to indirect billing rates. Per the compliance requirement, the auditee is required to liquidate all obligations incurred not later than 90 days after the period of performance end date. SRC does not believe that billing rate adjustments meet the definition of an "obligation" as defined in 2 FR section 200.71. "Obligation" means "orders placed for property and services, contracts and subawards made, and similar transactions."

This definition does not appear to include indirect cost rate adjustments which we believe would not become an "obligation" until they were finalized. In addition, SRC already evaluates its billing rates periodically throughout the year and re-submits adjustments to DCAA and DCMA when necessary. SRC believes that this process is already working as it should and does not need to be re-evaluated. Even if we were to create additional mid-year adjustments we would need to adjust again when the rates were considered audited and final, which would almost always be outside of the 90-day window. In addition, the rate adjustments in question happened to be inter-company adjustments. SRC does not believe any other subcontractors would be willing to re-evaluate their indirect rates at the end of every period of performance. Under DCAA's interpretation of the term "obligation," SRC could never be in compliance with this finding as a result. No further action will be taken related to indirect rate adjustments pending ACO determination.

Contact Person Responsible for Corrective Action: Danielle Chabot, Director, Compliance
Completion Date: As it relates to the one subcontract invoice in question, SRC will evaluate our processes and provide necessary training to all applicable employees. As it relates to the indirect rate adjustments, no further action will be taken pending ACO determination.

Finding 2018-004

SRC agrees that it should follow its policies and procedures related to price analysis and noncompetitive justifications and agrees that it can enhance its current practices by including more information in its price analysis and noncompetitive justification documentation. Management will conduct training with its procurement staff on both of these topics no later than 7/31/19. SRC disagrees with DCAA's interpretation of FAR 15.403-1 related to commercial item determinations. We believe that when evaluating the commercial item determinations for our subcontractors that any reference to "Contracting Officer" should be replaced with "SRC Procurement Representative". Under DCAA's interpretation of the FAR, a significant number of commercial item determinations would need to be evaluated by our ACO on a routine basis.

Contact Person Responsible for Corrective Action: Mark Halczyn, Manager, Subcontracts
Completion Date: Management will conduct training with its procurement staff by 7/31/19. No further action will be taking pending ACO determination.

Finding 2018-005

SRC will review the allocation of incentive compensation to ensure all applicable entities are appropriately sharing in the costs. In addition, SRC will update its disclosure statement to move incentive compensation costs from fringe into the overhead of each participating employee. This will ensure that for all home office employees that costs are adequately shared between all companies including SRC International.

Contact Person Responsible for Corrective Action: Danielle Chabot, Director, Compliance
Completion Date: SRC will review the allocation of incentive compensation by September 30, 2019. The update to the disclosure statement will be completed by August 1, 2019 and will be effective October 1, 2019.

SRC, Inc.
North Syracuse, NY

Summary Schedule of Claimed Expenditures by Federal Sponsor
For Fiscal Year Ended September 30, 2018

SRC, Inc.
North Syracuse, NY

Summary Schedule of Claimed Expenditures by Federal Sponsor
For Fiscal Year Ended September 30, 2018

Major Program-R&D Cluster	Federal CFDA Numbers	Expenditures Direct	Pass-Through	Total
Department of Defense:				
Department of the Air Force	12	$46,407,780	$6,516,501	$52,924,281
Department of the Army	12	45,670,314	28,068,840	73,739,154
Department of the Navy	12	2,010,148	2,382,617	4,392,765
Department of the Marines	12		102,846	102,846
Defense Intelligence Agency	12		76,341	76,341
Defense Advanced Research Projects Agency	12	7,429,226		7,429,226
Defense Threat Reduction Agency	12	847,157	5,209,003	6,056,159
National Reconnaissance Organization	12	1,183,379	1,365,464	2,548,843
National Security Agency	12		179,977	179,977
Defense Logistics Agency	12		6,825	6,825
Other Contracts	12	2,873,532		2,873,532
Total Department of Defense		$106,421,536	$43,908,415	$150,329,951
Other Federal Agencies				
Environmental Protection Agency	66	$4,874,003	$1,188,688	$6,062,691
Department of Health and Human Services	93	1,731,406		1,731,406
Department of Homeland Security	97	23,045	108,150	131,194
Department of State	19		1,288,130	1,288,130
Department of Transportation	20	69,211	13,422	82,633
Department of Energy	81		18,555	18,555
National Aeronautics and Space Administration	43	44,743	12,318	57,061
Office of the Director of National Intelligence	12		1,038,140	1,038,140
Total Other Federal Agencies		$6,742,409	$3,667,402	$10,409,811
Total Federal Awards		$113,163,945	$47,575,817	$160,739,762

**Minor differences due to rounding*