KRATOS DEFENSE & SECURITY SOLUTIONS, INC.
Form 10-Q
November 07, 2014

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

ý QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the Quarterly Period Ended September 28, 2014

¨ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES AND EXCHANGE ACT OF 1934

Commission file number 001-34460

KRATOS DEFENSE & SECURITY SOLUTIONS, INC.
(Exact name of Registrant as specified in its charter)

Delaware	13-3818604
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

4820 Eastgate Mall, Suite 200
San Diego, CA 92121
(858) 812-7300
(Address, including zip code, and telephone number, including area code, of Registrant's principal executive offices)

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ý No o

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (Section 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ý No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act:

Large accelerated filer o	Accelerated filer ý

Non-accelerated filer o
(Do not check if a smaller reporting company)

Smaller reporting company o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes o No ý

As of October 31, 2014, 57,796,295 shares of the registrant's common stock were outstanding.

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KRATOS DEFENSE & SECURITY SOLUTIONS, INC.

FORM 10-Q

FOR THE QUARTERLY PERIOD ENDED September 28, 2014

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements.

KRATOS DEFENSE & SECURITY SOLUTIONS, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(in millions, except par value and number of shares)
(Unaudited)

	December 29, 2013	September 28, 2014
Assets		
Current assets:		
Cash and cash equivalents	$55.7	$16.2
Restricted cash	5.0	5.2
Accounts receivable, net	265.8	255.1
Inventoried costs	74.6	80.4
Prepaid expenses	10.4	9.0
Other current assets	18.8	10.8
Total current assets	430.3	376.7
Property, plant and equipment, net	84.8	82.6
Goodwill	596.4	596.4
Intangible assets, net	69.9	57.8
Other assets	35.2	32.4
Total assets	$1,216.6	$1,145.9
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	$61.9	$49.2
Accrued expenses	46.2	37.0
Accrued compensation	44.9	37.1
Accrued interest	5.2	16.7
Billings in excess of costs and earnings on uncompleted contracts	52.5	47.2
Deferred income tax liability	28.4	28.4
Other current liabilities	11.9	11.6
Total current liabilities	251.0	227.2
Long-term debt principal, net of current portion	628.8	621.9
Long-term debt premium	14.5	—
Line of credit	—	41.0
Other long-term liabilities	26.5	24.8
Total liabilities	920.8	914.9
Commitments and contingencies		
Stockholders' equity:		
Preferred stock, $0.001 par value, 5,000,000 shares authorized, 0 shares outstanding at December 29, 2013 and September 28, 2014	—	—
Common stock, $0.001 par value, 195,000,000 shares authorized; 57,056,892 and 57,795,095 shares issued and outstanding at December 29, 2013 and September 28, 2014, respectively	—	—
Additional paid-in capital	856.0	867.2
Accumulated other comprehensive loss	(0.8)	(1.0)
Accumulated deficit	(559.4)	(635.2)
Total stockholders' equity	295.8	231.0

Total liabilities and stockholders’ equity	$1,216.6	$1,145.9

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

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KRATOS DEFENSE & SECURITY SOLUTIONS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME (LOSS)
(in millions, except per share amounts)
(Unaudited)

	Three Months Ended		Nine Months Ended	
	September 29, 2013	September 28, 2014	September 29, 2013	September 28, 2014
Service revenues	$108.8	$97.1	$335.0	$299.5
Product sales	117.6	120.0	379.9	347.0
Total revenues	226.4	217.1	714.9	646.5
Cost of service revenues	82.4	77.7	254.3	229.7
Cost of product sales	91.7	86.4	282.1	254.8
Total costs	174.1	164.1	536.4	484.5
Gross profit	52.3	53.0	178.5	162.0
Selling, general and administrative expenses	47.8	45.8	144.9	134.1
Merger and acquisition expenses	0.2	—	(2.3)	—
Research and development expenses	4.8	5.9	14.5	17.0
Unused office space and other restructuring	(6.6)	0.1	(5.0)	1.7
Operating income from continuing operations	6.1	1.2	26.4	9.2
Other income (expense):				
Interest expense, net	(16.2)	(12.1)	(48.7)	(42.2)
Loss on extinguishment of debt	—	—	—	(39.1)
Other income (expense), net	0.8	(0.4)	0.2	—
Total other expense, net	(15.4)	(12.5)	(48.5)	(81.3)
Loss from continuing operations before income taxes	(9.3)	(11.3)	(22.1)	(72.1)
Provision (benefit) for income taxes from continuing operations	0.2	(0.2)	2.9	3.7
Loss from continuing operations	(9.5)	(11.1)	(25.0)	(75.8)
Income (loss) from discontinued operations	(0.4)	0.2	(4.8)	—
Net loss	$(9.9)	$(10.9)	$(29.8)	$(75.8)
Basic and diluted loss per common share:				
Net loss from continuing operations	$(0.17)	$(0.19)	$(0.44)	$(1.32)
Net loss from discontinued operations	0.00	0.00	(0.08)	0.00
Net loss per common share	$(0.17)	$(0.19)	$(0.52)	$(1.32)
Basic and diluted weighted average shares outstanding	57.1	57.8	56.7	57.6
Comprehensive Loss				
Net loss from above	$(9.9)	$(10.9)	$(29.8)	$(75.8)
Change in cumulative translation adjustment	(0.1)	(0.1)	—	(0.2)
Comprehensive loss	$(10.0)	$(11.0)	$(29.8)	$(76.0)

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

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KRATOS DEFENSE & SECURITY SOLUTIONS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(in millions)
(Unaudited)

	Nine Months Ended September 29, 2013		September 28, 2014	
Operating activities:				
Net loss	$(29.8	)	$(75.8	)
Less: Loss from discontinued operations	(4.8	)	—	
Loss from continuing operations	(25.0	)	(75.8	)
Adjustments to reconcile loss from continuing operations to net cash provided by (used in) operating activities from continuing operations:				
Depreciation and amortization	40.7		29.2	
Stock-based compensation	6.0		7.6	
Amortization of deferred financing costs	3.9		2.5	
Amortization of premium and discount on Senior Secured Notes	(3.1	)	(1.1	)
Loss on extinguishment of debt	—		39.1	
Provision for doubtful accounts	0.8		1.2	
Changes in unused office space accrual	(6.8	)	0.2	
Changes in assets and liabilities, net of acquisitions:				
Accounts receivable	2.1		9.6	
Inventoried costs	10.9		(6.0	)
Prepaid expenses and other assets	0.3		0.8	
Accounts payable	(26.1	)	(12.7	)
Accrued compensation	(10.8	)	(7.8	)
Accrued expenses	(1.5	)	(9.2	)
Accrued interest payable	15.6		11.5	
Billings in excess of costs and earnings on uncompleted contracts	7.5		(7.4	)
Income tax receivable and payable	3.9		2.1	
Other liabilities	(7.4	)	(2.0	)
Net cash provided by (used in) operating activities from continuing operations	11.0		(18.2	)
Investing activities:				
Cash paid for acquisitions, net of cash acquired	2.2		(2.6	)
Proceeds from the sale of discontinued operations	0.4		—	
Increase (decrease) in restricted cash	0.5		(0.1	)
Capital expenditures	(12.2	)	(9.4	)
Net cash used in investing activities from continuing operations	(9.1	)	(12.1	)
Financing activities:				
Proceeds from issuance of long-term debt	—		618.5	
Extinguishment of long-term debt	—		(661.5	)
Debt issuance costs	—		(8.5	)
Credit agreement borrowings	—		41.0	
Cash paid for contingent acquisition consideration	(2.1	)	—	
Repayment of debt	(0.8	)	(0.7	)
Other	1.2		3.3	
Net cash used in financing activities from continuing operations	(1.7	)	(7.9	)
Net cash flows of continuing operations	0.2		(38.2	)
Net operating cash flows of discontinued operations	0.5		(1.2	)

Effect of exchange rate changes on cash and cash equivalents	0.1	(0.1)
Net increase (decrease) in cash and cash equivalents	0.8	(39.5)
Cash and cash equivalents at beginning of period	49.0	55.7
Cash and cash equivalents at end of period	$49.8	$16.2

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

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KRATOS DEFENSE & SECURITY SOLUTIONS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

Note 1. Summary of Significant Accounting Policies

All references to the “Company” and “Kratos” refer to Kratos Defense & Security Solutions, Inc., a Delaware corporation, and its subsidiaries.

(a) Basis of Presentation

The information as of September 28, 2014 and for the three and nine months ended September 29, 2013 and September 28, 2014 is unaudited. The condensed consolidated balance sheet as of December 29, 2013 was derived from the Company’s audited consolidated financial statements at that date. In the opinion of management, these unaudited condensed consolidated financial statements include all adjustments, consisting of normal recurring adjustments necessary for a fair presentation of the Company’s financial position, results of operations and cash flows for the interim periods presented. The results have been prepared in accordance with the instructions to Form 10-Q and do not necessarily include all information and footnotes necessary for presentation in accordance with accounting principles generally accepted in the United States (“GAAP”). These unaudited condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and the related notes included in the Company’s audited annual consolidated financial statements for the fiscal year ended December 29, 2013, included in the Company’s Annual Report on Form 10-K filed with the U.S. Securities and Exchange Commission ("SEC") on March 12, 2014 (the “Form 10-K”). Interim operating results are not necessarily indicative of operating results expected in subsequent periods or for the year as a whole.

(b) Principles of Consolidation

The condensed consolidated financial statements include the accounts of the Company and its 100% owned subsidiaries for which all inter-company transactions have been eliminated in consolidation.

(c) Fiscal Year

The Company has a 52/53 week fiscal year ending on the last Sunday of the calendar year, with interim fiscal periods ending on the last Sunday of each calendar quarter. The three and nine month periods ended September 29, 2013 and September 28, 2014 consisted of 13-week and 39-week periods, respectively. There are 52 calendar weeks in the fiscal years ending on December 29, 2013 and December 28, 2014.

(d) Accounting Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Such estimates include revenue recognition, allowance for doubtful accounts, warranties, inventory valuation, valuation of long-lived assets including identifiable intangibles and goodwill, accounting for income taxes including the related valuation allowance on the deferred tax asset and uncertain tax positions, contingencies and litigation, contingent acquisition consideration, stock-based compensation, losses on unused office space, and business combination purchase price allocations. In the future, the Company may realize actual results that differ from the current reported estimates. If the estimates that the Company has used change in the future, such changes could have a material impact on the Company's consolidated financial position, results of operations and cash flows.

In accounting for our long-term contracts for production of products and services provided to the U.S. Government and provided to our Public Safety & Security ("PSS") segment customers under fixed price contracts, we utilize both cost-to-cost and units delivered measures under the percentage-of-completion method of accounting in accordance with the provisions of Financial Accounting Standards Board (“FASB”) Accounting Standards Codification (“ASC”) Topic 605, Revenue Recognition.

Due to the size and nature of many of our contracts accounted for under the percentage-of-completion method of accounting, the estimation of total revenues and costs at completion is complicated and subject to many variables. For example,

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estimates are made regarding the length of time to complete a contract since costs also include expected increases in wages, prices for materials and allocated fixed costs. Similarly, assumptions are made regarding the future impact of our efficiency initiatives and cost reduction efforts. Incentives, awards or penalties related to performance on contracts are considered in estimating revenue and profit rates and are recorded when there is sufficient information to assess anticipated performance. Suppliers' assertions are also assessed and considered in estimating costs and profit rates. The Company closely monitors the consistent application of its critical accounting policies and compliance with contract accounting. Business operations personnel conduct periodic contract status and performance reviews. Also, regular and recurring evaluations of contract cost, scheduling and technical matters are performed by management personnel who are independent from the business operations personnel performing work under the contract. When adjustments in estimated contract revenues or costs are required, any significant changes from prior estimates are included in earnings in the current period ("the cumulative catch-up method").

(e) Accounting Standards Updates

In April 2014, the FASB issued Accounting Standards Update 2014-08 ("ASU 2014-08") "Presentation of Financial Statements (Topic 205) and Property, Plant, and Equipment (Topic 360): Reporting Discontinued Operations and Disclosures of Disposals of Components of an Entity". The amendments in the ASU 2014-08 change the criteria for reporting discontinued operations and requires enhanced disclosures in this area. Under the new guidance, only disposals representing a strategic shift in operations should be presented as discontinued operations. Those strategic shifts should have a major effect on the organization’s operations and financial results. Examples include a disposal of a major geographic area, a major line of business, or a major equity method investment. In addition, the new guidance requires expanded disclosures about discontinued operations that will provide financial statement users with more information about the assets, liabilities, income, and expenses of discontinued operations. The new guidance also requires disclosure of the pre-tax income attributable to a disposal of a significant part of an organization that does not qualify for discontinued operations reporting. The amendments in ASU 2014-08 are effective in the first quarter of 2015 for public organizations with calendar year ends. Early adoption is permitted. The Company does not believe that the adoption of this guidance will have a material impact on its condensed consolidated financial statements.

In May 2014, the FASB issued Accounting Standards Update 2014-09 ("ASU 2014-09") "Revenue from Contracts with Customers". ASU 2014-09 affects any entity using GAAP that either enters into contracts with customers to transfer goods or services or enters into contracts for the transfer of nonfinancial assets unless those contracts are within the scope of other standards (e.g., insurance contracts or lease contracts). ASU 2014-09 will supersede the revenue recognition requirements in Topic 605, Revenue Recognition, and most industry-specific guidance. The ASU also supersedes some cost guidance included in ASC Subtopic 605-35, Revenue Recognition—Construction-Type and Production-Type Contracts. For a public entity, the amendments in this ASU are effective for annual reporting periods beginning after December 15, 2016, including interim periods within that reporting period. Early application is not permitted. The guidance permits companies to either apply the requirements retrospectively to all prior periods presented or apply the requirements in the year of adoption, through a cumulative adjustment. The Company has not yet selected a transition method nor has it determined the impact of adoption on its condensed consolidated financial statements.

In August 2014, the FASB issued Accounting Standards Update 2014-15 ("ASU 2014-15") "Presentation of Financial Statements—Going Concern (Subtopic 205-40): Disclosure of Uncertainties about an Entity’s Ability to Continue as a Going Concern". ASU 2014-15 is intended to define management’s responsibility to evaluate whether there is substantial doubt about an organization’s ability to continue as a going concern and to provide related footnote disclosures. Under GAAP, financial statements are prepared under the presumption that the reporting organization will continue to operate as a going concern, except in limited circumstances. Financial reporting under this presumption is commonly referred to as the going concern basis of accounting. The going concern basis of accounting is critical to financial reporting because it establishes the fundamental basis for measuring and classifying assets and liabilities. Currently, GAAP lacks guidance about management’s responsibility to evaluate whether there is substantial doubt about the organization’s ability to continue as a going concern or to provide related footnote disclosures. ASU 2014-15 provides guidance to an organization’s management, with principles and definitions that are intended to reduce diversity in the timing and content of disclosures that are commonly provided by organizations today in the financial statement footnotes. The amendments are effective for annual periods ending after December 15, 2016, including interim periods within that reporting period. Early application is permitted for annual or interim reporting periods for which the financial statements have not previously been issued. The Company does not believe that the adoption of this guidance will have a material impact on its condensed consolidated financial statements.

There have been no changes in the Company's significant accounting policies for the nine months ended September 28, 2014 as compared to the significant accounting policies described in the Form 10-K.

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(f) Fair Value of Financial Instruments

The carrying amounts and the related estimated fair values of the Company's long-term debt financial instruments not measured at fair value on a recurring basis at December 29, 2013 and September 28, 2014 are presented in Note 8. The carrying value of all other financial instruments, including cash equivalents, accounts receivable, accounts payable, accrued expenses, billings in excess of cost and earnings on uncompleted contracts, income taxes payable and short-term debt, approximated their estimated fair values at December 29, 2013 and September 28, 2014 due to the short-term nature of these instruments.

Note 2. Goodwill and Intangible Assets

(a) Goodwill

The carrying amounts of goodwill as of December 29, 2013 and September 28, 2014 by reportable segment are as follows (in millions):

	Public Safety & Security	Kratos Government Solutions	Total
Gross value	$53.9	$789.9	$843.8
Less accumulated impairment	18.3	229.1	247.4
Net	$35.6	$560.8	$596.4

(b) Purchased Intangible Assets

The following table sets forth information for finite-lived and indefinite-lived intangible assets (in millions):

	As of December 29, 2013			As of September 28, 2014		
	Gross Value	Accumulated Amortization	Net Value	Gross Value	Accumulated Amortization	Net Value
Acquired finite-lived intangible assets:						
Customer relationships	$97.7	$(53.7)	$44.0	$99.0	$(66.5)	$32.5
Contracts and backlog	80.0	(78.7)	1.3	82.7	(79.7)	3.0
Developed technology and technical know-how	22.1	(8.6)	13.5	23.1	(10.3)	12.8
Trade names	6.1	(3.1)	3.0	6.1	(4.6)	1.5
Favorable operating lease	1.8	(0.6)	1.2	1.8	(0.7)	1.1
Total finite-lived intangible assets	207.7	(144.7)	63.0	212.7	(161.8)	50.9
Acquired indefinite-lived intangible assets:						
Trade names	6.9	—	6.9	6.9	—	6.9
Total intangible assets	$214.6	$(144.7)	$69.9	$219.6	$(161.8)	$57.8

Consolidated amortization expense related to intangible assets subject to amortization was $9.0 million and $5.7 million for the three months ended September 29, 2013 and September 28, 2014, respectively, and $27.3 million and $17.0 million for the nine months ended September 29, 2013 and September 28, 2014, respectively.

Note 3. Inventoried Costs

Inventoried costs are stated at the lower of cost or market. Cost is determined using the average cost or first-in, first-out method and is applied consistently within an operating entity. Inventoried costs include work in process under fixed-price

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contracts using costs as the basis of the percentage-of-completion calculation under the units of delivery method of revenue recognition. These costs represent accumulated contract costs less the portion of such costs allocated to delivered items. Accumulated contract costs include direct production costs, factory overhead and production tooling costs. Pursuant to contract provisions of U.S. Government contracts, such customers may have title to, or a security interest in, inventories related to such contracts as a result of advances, performance-based payments or progress payments. The Company reflects those advances and payments as an offset against the related inventory balances.

The Company regularly reviews inventory quantities on hand, future purchase commitments with its suppliers, and the estimated utility of its inventory. If the Company's review indicates a reduction in utility below carrying value, it reduces its inventory to a new cost basis.

Inventoried costs consisted of the following components (in millions):

	December 29, 2013	September 28, 2014
Raw materials	$44.5	$43.4
Work in process	24.3	32.1
Finished goods	4.6	4.4
Supplies and other	1.9	2.4
Subtotal inventoried costs	75.3	82.3
Less: Customer advances and progress payments	(0.7)	(1.9)
Total inventoried costs	$74.6	$80.4

Note 4. Stockholders' Equity

A summary of the changes in stockholders' equity is provided below (in millions):

	For the Nine Months Ended	
	September 29, 2013	September 28, 2014
Stockholders' equity at beginning of period	$324.1	$295.8
Comprehensive loss:		
Net loss	(29.8)	(75.8)
Foreign currency translation	—	(0.2)
Total comprehensive loss	(29.8)	(76.0)
Exercise of stock options and warrants	—	(0.1)
Stock-based compensation	6.0	7.6
Employee stock purchase plan and restricted stock units settled in cash	1.6	3.9
Restricted stock units traded for taxes	(0.2)	(0.2)
Stockholders' equity at end of period	$301.7	$231.0

The components of accumulated other comprehensive loss are as follows (in millions):

	September 29, 2013	September 28, 2014
Cumulative translation adjustment	$(0.3)	$(0.5)
Post retirement benefit reserve adjustment net of tax expense	(0.5)	(0.5)
Total accumulated other comprehensive loss	$(0.8)	$(1.0)

There were no reclassifications from other comprehensive income to net loss for the three and nine months ended September 29, 2013 or September 28, 2014.

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Common stock issued by the Company for the nine months ended September 29, 2013 and September 28, 2014 was as follows (in millions):

	For the Nine Months Ended	
	September 29, 2013	September 28, 2014
Shares outstanding at beginning of the period	56.6	57.1
Stock issued for employee stock purchase plan, stock options and restricted stock units exercised	0.4	0.7
Shares outstanding at end of the period	57.0	57.8

Note 5. Net Income (Loss) Per Common Share

The Company calculates net income (loss) per share in accordance with FASB ASC Topic 260, Earnings per Share ("Topic 260"). Under Topic 260, basic net income (loss) per common share is calculated by dividing net income (loss) by the weighted-average number of common shares outstanding during the reporting period. Diluted net income (loss) per common share reflects the effects of potentially dilutive securities.

Shares from stock options and awards, excluded from the calculation of diluted loss per share because their inclusion would have been anti-dilutive, were 1.9 million and 0.8 million for the three months ended September 29, 2013 and September 28, 2014, respectively, and 2.7 million and 0.9 million for the nine months ended September 29, 2013 and September 28, 2014, respectively.

Note 6. Income Taxes

A reconciliation of the total income tax provision (benefit), computed by applying the statutory federal income tax rate of 35% to loss from continuing operations before income tax provision, to the total income tax provision (benefit) for the three and nine months ended September 29, 2013 and September 28, 2014 is as follows (in millions):

	For the Three Months Ended		For the Nine Months Ended	
	September 29, 2013	September 28, 2014	September 29, 2013	September 28, 2014
Income tax benefit at federal statutory rate	$(3.3)	$(3.9)	$(7.7)	$(25.2)
State and foreign taxes, net of federal tax benefit and valuation allowance	—	(0.7)	1.6	0.1
Nondeductible expenses and other	—	0.5	0.4	1.3
Impact of deferred tax liabilities for indefinite-lived assets	0.2	(0.2)	2.9	2.9
Decrease in reserves for uncertain tax positions	(0.1)	(3.2)	(1.7)	(0.1)
Increase in federal valuation allowance	3.4	7.3	7.4	24.7
Total income tax provision (benefit)	$0.2	$(0.2)	$2.9	$3.7

In assessing the Company's ability to realize deferred tax assets, management considers, on a periodic basis, whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. As such, management has determined that it is appropriate to maintain a full valuation allowance against the Company's U.S. federal, combined state and certain foreign deferred tax assets, with the exception of an amount equal to its deferred tax liabilities, which can be expected to reverse over a definite life.

Federal and state income tax laws impose restrictions on the utilization of net operating loss (“NOL”) and tax credit carryforwards in the event that an “ownership change” occurs for tax purposes, as defined by Section 382 of the Internal Revenue Code of 1986, as amended (“Section 382”). In general, an ownership change occurs when shareholders owning 5% or more of a “loss corporation” (a corporation entitled to use NOL or other loss carryovers) have increased their ownership of stock in such corporation by more than 50 percentage points during any three-year period. The annual base Section 382

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limitation is calculated by multiplying the loss corporation's value at the time of the ownership change by the greater of the long-term tax-exempt rate determined by the Internal Revenue Service in the month of the ownership change or the two preceding months. This base limitation is subject to adjustments, including an increase for built-in gains recognized in the five-year period after the ownership change.

In March 2010, an “ownership change” occurred that will limit the utilization of NOL carryforwards. In July 2011, another “ownership change” occurred. The March 2010 ownership change limitation is more restrictive. In prior years, the company acquired corporations with NOL carryforwards at the date of acquisition ("Acquired NOLs"). The Acquired NOLs are subject to separate limitations that may further restrict the use of Acquired NOLs. As a result, the Company's federal annual utilization of NOL carryforwards will be limited to at least $27 million a year for the five years succeeding the March 2010 ownership change and at least $11.6 million for each year thereafter subject to separate limitations for Acquired NOLs. If the entire limitation amount is not utilized in a year, the excess can be carried forward and utilized in future years.

For the three and nine months ended September 28, 2014, there was no impact of such limitations on the income tax provision, since the amount of taxable income did not exceed the annual limitation amount. In addition, future equity offerings or acquisitions that have equity as a component of the purchase price could also cause an “ownership change.” If and when any other “ownership change” occurs, utilization of the NOL or other tax attributes may be further limited. As discussed elsewhere, deferred tax assets relating to the NOL and credit carryforwards are offset by a full valuation allowance. In addition, utilization of state tax loss carryforwards is dependent upon sufficient taxable income apportioned to the states.

The Company is subject to taxation in the U.S. and various state and foreign tax jurisdictions. The Company's tax years for 2000 and later are subject to examination by the U.S. and state tax authorities due to the existence of the NOL carryforwards. Generally, the Company's tax years for 2002 and later are subject to examination by various foreign tax authorities.

As of December 29, 2013, the Company had $15.8 million of unrecognized tax benefits that, if recognized, would impact the effective income tax rate, subject to possible offset by an increase in the deferred tax asset valuation allowance. During the nine months ended September 28, 2014, unrecognized tax benefits were decreased by $0.2 million relating to various current year and prior positions.

The Company recognizes interest and penalties related to unrecognized tax benefits in its provision for income taxes. During the nine months ended September 28, 2014 and September 29, 2013, a $0.1 million expense was recorded related to interest and penalties. The Company recorded a benefit for interest and penalties related to the reversal of prior position of $0.2 million for the nine months ended September 29, 2013. There was no material benefit recorded for the nine months ended September 28, 2014. The Company believes that no significant amount of the liabilities for uncertain tax positions will expire within twelve months of September 28, 2014.

Note 7. Discontinued Operations

In June 2012, consistent with its plans to complete an assessment and evaluation of the non-core businesses acquired in the Integral acquisition, the Company committed to a plan to sell certain lines of business associated with antennas, satellite-cased products and fly-away terminals. These operations were previously reported in the Kratos Government Solutions ("KGS") segment, and in accordance with ASC Topic 205, Presentation of Financial Statements ("Topic 205"), these businesses were classified as held for sale and reported in discontinued operations in the accompanying condensed consolidated financial statements.

In the second quarter of 2012, the Company recorded a $1.5 million impairment charge associated with the portion of goodwill that was allocated to the discontinued businesses based on management's estimate of the fair value of the business. The Company sold its domestic operations to two buyers for approximately $0.8 million in cash consideration and the assumption of certain liabilities. The Company received $0.3 million in cash in 2012 from the first buyer and $0.5 million in cash in April 2013 from the second buyer. The Company recorded a $1.2 million impairment charge in the first quarter of 2013 related to its revised estimate of the fair value of these operations.

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The following table presents the results of discontinued operations (in millions):

	For the Three Months Ended		For the Nine Months Ended	
	September 29, 2013	September 28, 2014	September 29, 2013	September 28, 2014
Revenue	$—	$—	$3.6	$—
Net income (loss) before taxes	$(0.4)	$0.2	$(4.8)	$—

The following is a summary of the liabilities of discontinued operations, which are in other current liabilities and other long-term liabilities in the accompanying condensed consolidated balance sheets as of December 29, 2013 and September 28, 2014 (in millions):

	December 29, 2013	September 28, 2014
Accounts payable and accrued expenses	$1.1	$0.8
Other current liabilities	1.4	0.8
Current liabilities of discontinued operations	$2.5	$1.6
Other long-term liabilities	$0.2	$—

Note 8. Debt

(a) Issuance of 7.00% Senior Secured Notes due 2019

In May 2014, the Company refinanced its $625.0 million 10% Senior Secured Notes due in 2017 (the "10% Notes") with $625.0 million of newly issued 7.00% Senior Secured Notes due in 2019 (the "7% Notes"). The net proceeds of the 7% Notes was $618.5 million after an original issue discount of $6.5 million. The Company incurred debt issuance costs of $8.6 million associated with the new 7% Notes. The Company utilized the net proceeds from the 7% Notes, a $41.0 million draw on a new credit agreement discussed below, as well as cash from operations to extinguish the 10% Notes. The total reacquisition price of the 10% Notes was $661.5 million including a $31.2 million early termination fee, the write off of $15.5 million of unamortized issue costs, $12.9 million of unamortized premium, along with $5.3 million of additional interest while in escrow, which resulted in a loss on extinguishment of $39.1 million.

The Company completed the offering of the 7.00% Notes (hereafter the "Notes”) in a private placement conducted pursuant to Rule 144A and Regulation S under the Securities Act of 1933, as amended (the “Act”). The Notes are governed by an Indenture dated May 14, 2014 (the “Indenture”) among the Company, certain of the Company’s subsidiaries (the “Guarantors”) and Wilmington Trust, National Association, as Trustee and Collateral Agent. A Guarantor can be released from its Guarantee if (a) all of the Capital Stock issued by such Guarantor or all or substantially all of the assets of such Guarantor are sold or otherwise disposed of; (b) the Company designates such Guarantor as an Unrestricted Subsidiary; (c) if the Company exercises its legal defeasance option or its covenant defeasance option; (d) upon satisfaction and discharge of the Indenture or payment in full in cash of the principal of, premium, if any, accrued and unpaid interest.

The holders of the Notes have a first priority lien on substantially all of the Company's assets and the assets of the Guarantors, except with respect to accounts receivable, inventory, deposit accounts, securities accounts, cash, securities and general intangibles (other than intellectual property), on which the holders of the Notes have a second priority lien to the new $110.0 million credit agreement.

The Company pays interest on the Notes semi-annually, in arrears, on May 15 and November 15 of each year.
The Notes include customary covenants and events of default as well as a consolidated fixed charge ratio of 2.0:1 for the incurrence of additional indebtedness. Negative covenants include, among other things, limitations on additional debt, liens, negative pledges, investments, dividends, stock repurchases, asset sales and affiliate transactions. Events of default include, among other events, non-performance of covenants, breach of representations, cross-default to other material debt, bankruptcy,

insolvency, material judgments and changes in control. As of September 28, 2014, the Company was in compliance with the covenants contained in the Indenture governing the Notes.

On or after May 15, 2016, the Company may redeem some or all of the Notes at 105.25% of the aggregate principal amount of such notes through May 15, 2017, 102.625% of the aggregate principal amount of such notes through May 15, 2018 and 100% of the aggregate principal amount of such notes thereafter, plus accrued and unpaid interest to the date of redemption. In addition, the Company may redeem up to 35% of the Notes at 107% of the aggregate principal amount of such notes plus accrued and unpaid interest before May 15, 2016 with the net proceeds of certain equity offerings. The Company may also redeem some or all of the Notes before May 15, 2016 at a redemption price of 100% of the principal amount thereof plus accrued and unpaid interest, if any, to the redemption date, plus a “make whole” premium. In addition, at one time prior to May 15, 2016, the Company may redeem up to 10% of the original aggregate principal amount of the Notes issued under the Indenture at a redemption price of 103% of the principal amount thereof, plus accrued and unpaid interest to the date of redemption.

On September 17, 2014, the Company commenced an offer to exchange the outstanding Notes for an equal amount of new 7.00% Senior Secured Notes due 2019 (the “Exchange Notes”) that have been registered under the Securities Act of 1933, as amended. The Company made the exchange offer pursuant to the terms of the Registration Rights Agreement, dated May 14, 2014, that it entered into with the Guarantors and the representative of the initial purchasers of the Notes. The purpose of the exchange offer was to allow holders of the Notes to exchange their Notes for Exchange Notes that are not subject to transfer restrictions. The terms of the Exchange Notes are identical in all material respects to the terms of the Notes, except the Exchange Notes have been registered under the Securities Act. The Exchange Notes are fully and unconditionally guaranteed, jointly and severally, on a senior secured basis by the Company and each of its subsidiaries, as the guarantors thereof. The Company pays interest on the Exchange Notes semi-annually, in arrears, on May 15 and November 15 of each year. The Company completed the exchange offer on October 16, 2014, at which time the holders of all outstanding Notes had elected to exchange their Notes for Exchange Notes. The Company has no further obligations under the Registration Rights Agreement.

(b) Other Indebtedness

$110.0 Million Credit Agreement

On May 14, 2014, the Company replaced its credit facility with KeyBank National Association and entered into a Credit and Security Agreement (the “Credit Agreement”), by and among the Company, the lenders from time to time party thereto, SunTrust Bank, as Agent (the “Agent”), PNC Bank, National Association, as Joint Lead Arranger and Documentation Agent and SunTrust Robinson Humphrey, Inc., as Joint Lead Arranger and Sole Book Runner. The Credit Agreement establishes a five-year senior secured revolving credit facility in the maximum amount of $110.0 million (subject to a potential increase of the maximum principal amount to $135.0 million, subject to the Agent's and applicable lenders’ approval as described therein), consisting of a subline for letters of credit in an amount not to exceed $50.0 million, as well as a swingline loan in an aggregate principal amount at any time outstanding not to exceed $10.0 million. The Credit Agreement is secured by a lien on substantially all of the Company's assets and the assets of the guarantors thereunder, subject to certain exceptions and permitted liens. The Credit Agreement has a first priority lien on accounts receivable, inventory, deposit accounts, securities accounts, cash, securities and general intangibles (other than intellectual property). On all other assets, the Credit Agreement has a second priority lien junior to the lien securing the Notes.

The Credit Agreement contains certain covenants, which include, but are not limited to, restrictions on indebtedness, liens, and investments, and places limits on other various payments, as well as a financial covenant relating to a minimum fixed charge coverage ratio of 1.15:1. Events of default under the terms of the Credit Agreement include, but are not limited to: failure of the Company to pay any principal of any loans in full when due and payable; failure of the Company to pay any interest on any loan or any fee or other amount payable under the Credit Agreement within three business days after the date when due and payable; failure of the Company or any of its subsidiaries to comply with certain covenants and agreements, subject to applicable grace periods and/or notice requirements; or any representation, warranty or statement made in or pursuant to the Credit Agreement or any related writing or any other material information furnished by the Company or any of its subsidiaries to the Agent or the lenders shall prove to be false or erroneous. Subject to certain notice requirements and other conditions, upon the occurrence of an event of default, commitments may be terminated and the principal of, and interest then outstanding on, all of the loans may become immediately due and payable. However, where an event of default arises from certain bankruptcy events, the commitments shall automatically and immediately terminate and the principal of, and interest then outstanding on, all of the loans shall become immediately due and payable.

Borrowings under the revolving Credit Agreement may take the form of a base rate revolving loan, Eurodollar revolving loan or swingline loan. Base rate revolving loans and swingline loans will bear interest at a rate per annum equal to the sum of

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the applicable margin from time to time in effect plus the highest of (i) the Agent's prime lending rate, as in effect at such time, (ii) the federal funds rate, as in effect at such time, plus 0.50% per annum, and (iii) the adjusted LIBOR rate determined at such time for an interest period of one month, plus 1.00% per annum. Eurodollar revolving loans will bear interest at a rate per annum equal to the sum of the applicable margin from time to time in effect plus the adjusted LIBOR rate. The applicable margin varies between 1.50% - 2.00% for base rate revolving loans and swingline loans and 2.50% - 3.00% for Eurodollar loans, and is based on several factors including the Company's then-existing borrowing base and the Lender's total commitment amount and revolving credit exposure. The calculation of the Company's borrowing base takes into account several items relating to the Company and its subsidiaries, including amounts due and owing under billed and unbilled accounts receivables, then-held eligible raw materials inventory, work-in-process inventory, and applicable reserves. As of September 28, 2014, there was $41.0 million outstanding on the Credit Agreement and $12.4 million was outstanding on letters of credit, resulting in net borrowing base availability of $43.3 million. The Company was in compliance with the financial covenants of the Credit Agreement as of September 28, 2014.

Debt Acquired in Acquisition

The Company has a 10-year term loan with a bank in Israel entered into on September 16, 2008 in connection with the acquisition of one of its wholly owned subsidiaries. The balance as of September 28, 2014 was $4.0 million, and the loan is payable in quarterly installments of $0.3 million plus interest at LIBOR plus a margin of 1.5%. The loan agreement contains various covenants, including a minimum net equity covenant as defined in the loan agreement. The Company was in compliance with all covenants, including the minimum net equity covenant, as of September 28, 2014.

Fair Value of Long-term Debt

Carrying amounts and the related estimated fair values of the Company's long-term debt financial instruments not measured at fair value on a recurring basis at December 29, 2013 and September 28, 2014 are presented in the following table:

	As of December 29, 2013			As of September 28, 2014		
$ in millions	Principal	Carrying Amount	Fair Value	Principal	Carrying Amount	Fair Value
Total Long-term debt including current portion	$629.8	$644.3	$679.7	$670.0	$663.9	$671.0

The fair value of the Company's long-term debt as of December 29, 2013 was based upon actual trading activity (Level 1, Observable inputs that reflect quoted prices in active markets). The fair value of the Company's long-term debt as of September 28, 2014 was based upon broker reported trading activity by sophisticated investors (Level 2, Quoted prices in markets that are not active). The fair value at both December 29, 2013 and September 28, 2014 is the estimated amount the Company would have to pay to repurchase its debt, including any premium or discount attributable to the difference between the stated interest rate and market value of interest at the balance sheet date.

The net unamortized original issue discount of $6.1 million as of September 28, 2014, which is the difference between the carrying amount of $663.9 million and the principal amount of $670.0 million presented in the previous table, is being accreted to interest expense over the term of the related debt.

Note 9. Segment Information

The Company operates in two principal reportable business segments: Kratos Government Solutions ("KGS") and Public Safety & Security ("PSS"). The Company organizes its reportable business segments based on the nature of the products, solutions and services offered, the nature of the production processes, the type or class of customer for their products and services, the methods used to distribute their products or provide their services, and the nature of the regulatory environment. The KGS reportable business segment has five operating segments: Defense Rocket Support Services, Electronic Products, Technical and Training Solutions, Modular Systems, and Unmanned Systems. All of the KGS operating divisions provide technology based defense solutions, involving products and services, primarily for mission critical United States National Security priorities, with the primary focus relating to the nation’s C5ISR requirements. The PSS reportable business segment provides integrated solutions for advanced homeland security, public safety, critical infrastructure security, and security and surveillance systems for government, industrial and commercial customers.

Revenues, depreciation and amortization, and operating income generated by the Company’s reportable segments for the three and nine month periods ended September 29, 2013 and September 28, 2014 are as follows (in millions):

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	Three Months Ended		Nine Months Ended	
	September 29, 2013	September 28, 2014	September 29, 2013	September 28, 2014
Revenues:				
Kratos Government Solutions				
Service revenues	$57.0	$54.3	$180.9	$157.2
Product sales	117.6	120.0	379.9	334.0
Total Kratos Government Solutions	174.6	174.3	560.8	491.2
Public Safety & Security				
Service revenues	51.8	42.8	154.1	142.3
Product sales	—	—	—	13.0
Total Public Safety & Security	51.8	42.8	154.1	155.3
Total revenues	$226.4	$217.1	$714.9	$646.5
Depreciation & amortization:				
Kratos Government Solutions	$12.1	$9.4	$38.0	$27.7
Public Safety & Security	0.8	0.5	2.7	1.5
Total depreciation and amortization	$12.9	$9.9	$40.7	$29.2
Operating income:				
Kratos Government Solutions	$6.4	$8.2	$23.8	$17.6
Public Safety & Security	1.8	(4.1)	5.7	(0.1)
Unallocated corporate expense, net	(2.1)	(2.9)	(3.1)	(8.3)
Total operating income	$6.1	$1.2	$26.4	$9.2

Total operating income of the reportable business segments is reconciled to the corresponding consolidated amount. The reconciling item “Unallocated corporate expense, net” includes costs for certain stock-based compensation programs, the effects of items not considered part of management’s evaluation of segment operating performance, merger and acquisition expenses, corporate costs not allocated to the operating segments, and other miscellaneous corporate activities. Transactions between segments are generally negotiated and accounted for under terms and conditions similar to other government and commercial contracts.

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Note 10. Significant Customers

Revenue from the U.S. Government, which includes foreign military sales, includes revenue from contracts for which the Company is the prime contractor as well as those for which the Company is a subcontractor and the ultimate customer is the U.S. Government. The KGS segment has substantial revenue from the U.S. Government. Sales to the U.S. Government amounted to approximately $143.4 million and $139.1 million, or 63% and 64% of total Kratos revenue, for the three months ended September 29, 2013 and September 28, 2014, respectively, and approximately $460.9 million and $378.4 million, or 64% and 59% of total revenue, for the nine months ended September 29, 2013 and September 28, 2014, respectively.

Note 11. Commitments and Contingencies

(a) Legal Matters

In addition to commitments and obligations in the ordinary course of business, the Company is subject to various claims, pending and potential legal actions for damages, investigations relating to governmental laws and regulations and other matters arising out of the normal conduct of its business. The Company assesses contingencies to determine the degree of probability and range of possible loss for potential accrual in its condensed consolidated financial statements. An estimated loss contingency is accrued in the Company's condensed consolidated financial statements if it is probable that a liability has been incurred and the amount of the loss can be reasonably estimated. Because litigation and legal matters are inherently unpredictable and unfavorable resolutions could occur, assessing litigation and legal matter contingencies is highly subjective and requires judgments about future events. When evaluating contingencies, the Company may be unable to provide a meaningful estimate due to a number of factors, including the procedural status of the matter in question, the presence of complex or novel legal theories, and/or the ongoing discovery and development of information important to the matters. In addition, damage amounts claimed in litigation against the Company may be unsupported, exaggerated or unrelated to possible outcomes, and as such are not meaningful indicators of the Company's potential liability. The Company regularly reviews contingencies to determine the adequacy of its accruals and related disclosures. The amount of ultimate loss may differ from these estimates. It is possible that cash flows or results of operations could be materially affected in any particular period by the unfavorable resolution of one or more of these contingencies. Whether any losses finally determined in any claim, action, investigation or proceeding could reasonably have a material effect on the Company's business, financial condition, results of operations or cash flows will depend on a number of variables, including the timing and amount of such losses; the structure and type of any remedies; the monetary significance of any such losses, damages or remedies on the Company's condensed consolidated financial statements; and the unique facts and circumstances of the particular matter that may give rise to additional factors.

Regulatory Matters

U.S. Government Cost Claims. The Company's contracts with the Department of Defense are subject to audit by the Defense Contract Audit Agency (“DCAA”). As a result of these audits, from time to time the Company is advised of claims concerning potential disallowed, overstated or disputed costs. For example, during the course of its current audits, the DCAA is closely examining and questioning certain of its established and disclosed practices that it had previously audited and accepted. In addition, based on a DCAA audit, the U.S. Department of Justice is currently investigating whether one of the Company's subsidiaries violated the federal False Claims Act by overstating its labor and material costs in a contract with the Department of Defense prior to the Company's acquisition of the subsidiary. Under the False Claims Act, the Department of Justice can seek civil penalties plus treble damages. The Company intends to defend itself in these matters and to work to resolve or settle any disputed contract costs. When appropriate, the Company records accruals to reflect its expected exposure to the matters raised by the U.S. Government. The Company reviews such accruals on a quarterly basis for sufficiency based on the most recent information available. Based on its assessment, the Company has accrued an amount in its financial statements for contingent liabilities associated with these matters that it considers to be immaterial to its overall financial position. The matter that is currently being investigated was identified during the acquisition process and was taken into consideration in the purchase price allocation of this subsidiary. Contract disputes with the U.S. Government, however, are inherently unpredictable, and unfavorable resolutions could occur. As a result, assessing contingencies is highly subjective and requires judgment about future events. The amount of ultimate loss may exceed the Company's current accruals, and it is possible that its cash flows or results of operations could be materially affected in any particular period by the unfavorable resolution of one or more of these contingencies.

Other Litigation Matters. The Company is subject to normal and routine litigation arising from the ordinary course and conduct of business and, at times, as a result of acquisitions and dispositions. Such disputes include, for example, commercial, employment, intellectual property, environmental and securities matters. The aggregate amounts accrued related to these matters are not material to the total liabilities of the Company. We intend to defend ourselves in any such matters and do

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not currently believe that the outcome of any such matters will have a material adverse impact on our financial condition, results of operations or cash flows.

(b) Warranty

Certain of the Company’s products, product finishes, and services are covered by a warranty to be free from defects in material and workmanship for periods ranging from one to ten years. Optional extended warranty contracts can also be purchased with the revenue deferred and amortized over the extended warranty period. The Company accrues a warranty liability for estimated costs to provide products, parts or services to repair or replace products in satisfaction of warranty obligations. Warranty revenues related to extended warranty contracts are amortized to income, over the life of the contract, using the straight-line method. Costs under extended warranty contracts are expensed as incurred.

The Company’s estimate of costs to service its warranty obligations is based upon historical experience and expectations of future conditions. To the extent that the Company experiences any changes in warranty claim activity or costs associated with servicing those claims, its warranty liability is adjusted accordingly.

The changes in the Company's aggregate product warranty liabilities, which are included in other current liabilities and other long term-liabilities on the Company's condensed consolidated balance sheets, were as follows (in millions):

	Nine Months Ended	
	September 29, 2013	September 28, 2014
Balance at beginning of the period	$5.2	$5.4
Costs accrued and revenues deferred	0.3	0.6
Settlements made (in cash or kind) and revenues recognized and other	(0.6)	(0.5)
Balance at end of period	4.9	5.5
Less: Current portion	(4.6)	(5.1)
Non-current accrued product warranty and deferred warranty revenue	$0.3	$0.4

Note 12. Condensed Consolidating Financial Statements

The Company has $625.0 million in outstanding Senior Secured Notes (see Note 8). The Notes are guaranteed by all of the Company's 100% owned domestic subsidiaries (the "Subsidiary Guarantors") and are collateralized by the assets of all of the Company's 100% owned subsidiaries. The Notes are fully and unconditionally guaranteed on a joint and several basis by each Subsidiary Guarantor and the Company. There are no contractual restrictions limiting cash transfers from Subsidiary Guarantors by dividends, loans or advances to the Company. The Senior Secured Notes are not guaranteed by the Company's foreign subsidiaries (the “Non-Guarantor Subsidiaries”).

The following tables present condensed consolidating financial statements for the parent company, the Subsidiary Guarantors and the Non-Guarantor Subsidiaries, respectively. The condensed consolidating financial information below follows the same accounting policies as described in the condensed consolidated financial statements, except for the use of the equity method of accounting to reflect ownership interests in 100% owned subsidiaries, which are eliminated upon consolidation. Subsequent to the issuance of the Company’s condensed consolidated financial statements for the quarter ended September 29, 2013, the Company reclassified cash flows related to Investment in affiliated companies to a separate line item in its Condensed Consolidating Statement of Cash Flows. These amounts were previously combined with financings from affiliated companies. There was no total impact on cash flow from either investing or financing activities.

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Condensed Consolidating Balance Sheet
December 29, 2013
(Unaudited)
(in millions)

	Parent Company	Guarantors on a Combined Basis	Non-Guarantors on a Combined Basis	Eliminations	Consolidated
Assets					
Current Assets:					
Cash and cash equivalents	$42.7	$(3.0)	$16.0	$—	$55.7
Accounts receivable, net	—	238.6	27.2	—	265.8
Amounts due from affiliated companies	410.2	—	—	(410.2)	—
Inventoried costs	—	59.1	15.5	—	74.6
Other current assets	10.7	19.4	4.1	—	34.2
Total current assets	463.6	314.1	62.8	(410.2)	430.3
Property, plant and equipment, net	2.1	71.9	10.8	—	84.8
Goodwill	—	574.8	21.6	—	596.4
Intangible assets, net	—	68.5	1.4	—	69.9
Investment in subsidiaries	474.2	36.7	—	(510.9)	—
Amounts due from affiliated companies	—	24.0	—	(24.0)	—
Other assets	12.9	23.0	(0.7)	—	35.2
Total assets	$952.8	$1,113.0	$95.9	$(945.1)	$1,216.6
Liabilities and Stockholders' Equity					
Current liabilities:					
Accounts payable	$2.8	$54.1	$5.0	$—	$61.9
Accrued expenses	6.6	40.9	3.9	—	51.4
Accrued compensation	4.0	36.9	4.0	—	44.9
Billings in excess of costs and earnings on uncompleted contracts	—	45.4	7.1	—	52.5
Deferred income tax liability	—	28.4	—	—	28.4
Amounts due to affiliated companies	—	390.2	20.0	(410.2)	—
Other current liabilities	1.3	9.5	1.1	—	11.9
Total current liabilities	14.7	605.4	41.1	(410.2)	251.0
Long-term debt, net of current portion	639.5		3.8	—	643.3
Amounts due to affiliated companies	—	—	24.0	(24.0)	—
Other long-term liabilities	2.8	21.4	2.3	—	26.5
Total liabilities	657.0	626.8	71.2	(434.2)	920.8
Total stockholders' equity	295.8	486.2	24.7	(510.9)	295.8
Total liabilities and stockholders' equity	$952.8	$1,113.0	$95.9	$(945.1)	$1,216.6

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Condensed Consolidating Balance Sheet
September 28, 2014
(Unaudited)
(in millions)

	Parent Company	Guarantors on a Combined Basis	Non-Guarantors on a Combined Basis	Eliminations	Consolidated
Assets					
Current Assets:					
Cash and cash equivalents	$13.7	$(5.9)	$8.4	$—	$16.2
Accounts receivable, net	—	223.7	31.4	—	255.1
Amounts due from affiliated companies	398.1	—	—	(398.1)	—
Inventoried costs	—	61.7	18.7	—	80.4
Other current assets	5.0	16.1	3.9	—	25.0
Total current assets	416.8	295.6	62.4	(398.1)	376.7
Amounts due from affiliated companies, long-term	—	24.0	—	(24.0)	—
Property, plant and equipment, net	2.0	70.3	10.3	—	82.6
Goodwill	—	572.4	24.0	—	596.4
Intangible assets, net	—	57.4	0.4	—	57.8
Investment in subsidiaries	492.2	41.9	—	(534.1)	—
Other assets	7.9	24.5	—	—	32.4
Total assets	$918.9	$1,086.1	$97.1	$(956.2)	$1,145.9
Liabilities and Stockholders' Equity					
Current liabilities:					
Accounts payable	$3.2	$41.9	$4.1	$—	$49.2
Accrued expenses	17.4	32.2	4.1	—	53.7
Accrued compensation	4.1	29.4	3.6	—	37.1
Billings in excess of costs and earnings on uncompleted contracts	—	40.9	6.3	—	47.2
Deferred income tax liability	(0.8)	29.2	—	—	28.4
Amounts due to affiliated companies	—	379.2	18.9	(398.1)	—
Other current liabilities	1.0	9.6	1.0	—	11.6
Total current liabilities	24.9	562.4	38.0	(398.1)	227.2
Long-term debt, net of current portion	659.9	—	3.0	—	662.9
Amounts due to affiliated companies	—	—	24.0	(24.0)	—
Other long-term liabilities	3.1	19.5	2.2	—	24.8
Total liabilities	687.9	581.9	67.2	(422.1)	914.9
Total stockholders' equity	231.0	504.2	29.9	(534.1)	231.0
Total liabilities and stockholders' equity	$918.9	$1,086.1	$97.1	$(956.2)	$1,145.9

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Condensed Consolidating Statement of Operations and Comprehensive Income (Loss)
Three Months Ended September 29, 2013
(Unaudited)
(in millions)

	Parent Company	Guarantors on a Combined Basis	Non-Guarantors on a Combined Basis	Eliminations	Consolidated
Service revenues	$—	$107.6	$1.2	$—	$108.8
Product sales	—	103.9	17.5	(3.8)	117.6
Total revenues	—	211.5	18.7	(3.8)	226.4
Cost of service revenues	—	81.7	0.7	—	82.4
Cost of product sales	—	82.2	13.3	(3.8)	91.7
Total costs	—	163.9	14.0	(3.8)	174.1
Gross profit	—	47.6	4.7	—	52.3
Selling, general and administrative expenses	1.4	36.2	3.8	—	41.4
Research and development expenses	—	4.7	0.1	—	4.8
Operating income (loss) from continuing operations	(1.4)	6.7	0.8	—	6.1
Other income (expense):					
Interest expense, net	(16.2)	0.1	(0.1)	—	(16.2)
Other income (expense), net	—	0.2	0.6	—	0.8
Total other income and expense, net	(16.2)	0.3	0.5	—	(15.4)
Income (loss) from continuing operations before income taxes	(17.6)	7.0	1.3	—	(9.3)
Provision (benefit) for income taxes from continuing operations	—	(0.1)	0.3	—	0.2
Income (loss) from continuing operations	(17.6)	7.1	1.0	—	(9.5)
Loss from discontinued operations	—	(0.4)	—	—	(0.4)
Equity in net income (loss) of subsidiaries	7.7	1.0	—	(8.7)	—
Net income (loss)	$(9.9)	$7.7	$1.0	$(8.7)	$(9.9)
Comprehensive income (loss)	$(10.0)	$7.7	$0.9	$(8.6)	$(10.0)

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Condensed Consolidating Statement of Operations and Comprehensive Income (Loss)
Three Months Ended September 28, 2014
(Unaudited)
(in millions)

	Parent Company	Guarantors on a Combined Basis	Non-Guarantors on a Combined Basis	Eliminations	Consolidated
Service revenues	$—	$94.1	$3.0	$—	$97.1
Product sales	—	103.4	18.6	(2.0)	120.0
Total revenues	—	197.5	21.6	(2.0)	217.1
Cost of service revenues	—	75.4	2.3	—	77.7
Cost of product sales	—	76.9	11.5	(2.0)	86.4
Total costs	—	152.3	13.8	(2.0)	164.1
Gross profit	—	45.2	7.8	—	53.0
Selling, general and administrative expenses	2.9	39.5	3.5	—	45.9
Research and development expenses	—	5.5	0.4	—	5.9
Operating income (loss) from continuing operations	(2.9)	0.2	3.9	—	1.2
Other income (expense):					
Interest expense, net	(12.2)	—	0.1	—	(12.1)
Loss on extinguishment of debt	—	—	—	—	—
Other income (expense), net	—	0.1	(0.5)	—	(0.4)
Total other income and expense, net	(12.2)	0.1	(0.4)	—	(12.5)
Income (loss) from continuing operations before income taxes	(15.1)	0.3	3.5	—	(11.3)
Provision (benefit) for income taxes from continuing operations	0.4	(1.2)	0.6	—	(0.2)
Income (loss) from continuing operations	(15.5)	1.5	2.9	—	(11.1)
Income (loss) from discontinued operations	0.2	—	—	—	0.2
Equity in net income (loss) of subsidiaries	4.4	2.9	—	(7.3)	—
Net income (loss)	$(10.9)	$4.4	$2.9	$(7.3)	$(10.9)
Comprehensive income (loss)	$(11.0)	$4.4	$2.8	$(7.2)	$(11.0)

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Condensed Consolidating Statement of Operations and Comprehensive Income (Loss)
Nine Months Ended September 29, 2013
(Unaudited)
(in millions)

	Parent Company	Guarantors on a Combined Basis	Non-Guarantors on a Combined Basis	Eliminations	Consolidated
Service revenues	$—	$332.4	$2.6	$—	$335.0
Product sales	—	338.1	55.1	(13.3)	379.9
Total revenues	—	670.5	57.7	(13.3)	714.9
Cost of service revenues	—	252.5	1.8	—	254.3
Cost of product sales	—	255.7	39.7	(13.3)	282.1
Total costs	—	508.2	41.5	(13.3)	536.4
Gross profit	—	162.3	16.2	—	178.5
Selling, general and administrative expenses	5.1	122.4	10.1	—	137.6
Research and development expenses	—	13.7	0.8	—	14.5
Operating income (loss)from continuing operations	(5.1)	26.2	5.3	—	26.4
Other income (expense):					
Interest expense, net	(48.4)	0.1	(0.4)	—	(48.7)
Other income (expense), net	—	0.3	(0.1)	—	0.2
Total other expense, net	(48.4)	0.4	(0.5)	—	(48.5)
Income (loss) from continuing operations before income taxes	(53.5)	26.6	4.8	—	(22.1)
Provision for income taxes from continuing operations	0.5	1.9	0.5	—	2.9
Income (loss) from continuing operations	(54.0)	24.7	4.3	—	(25.0)
Income (loss) from discontinued operations	0.1	(4.9)	—	—	(4.8)
Equity in net income (loss) of subsidiaries	24.1	4.3	—	(28.4)	—
Net income (loss)	$(29.8)	$24.1	$4.3	$(28.4)	$(29.8)
Comprehensive income (loss)	$(29.8)	$24.1	$4.3	$(28.4)	$(29.8)

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Condensed Consolidating Statement of Operations and Comprehensive Income (Loss)
Nine Months Ended September 28, 2014
(Unaudited)
(in millions)

	Parent Company	Guarantors on a Combined Basis	Non-Guarantors on a Combined Basis	Eliminations	Consolidated
Service revenues	$—	$292.3	$7.2	$—	$299.5
Product sales	—	304.4	50.3	(7.7)	347.0
Total revenues	—	596.7	57.5	(7.7)	646.5
Cost of service revenues	—	224.1	5.6	—	229.7
Cost of product sales	—	228.4	34.1	(7.7)	254.8
Total costs	—	452.5	39.7	(7.7)	484.5
Gross profit	—	144.2	17.8	—	162.0
Selling, general and administrative expenses	11.9	113.8	10.1	—	135.8
Research and development expenses	—	15.8	1.2	—	17.0
Operating income from continuing operations	(11.9)	14.6	6.5	—	9.2
Other income (expense):					
Interest expense, net	(42.1)	0.1	(0.2)	—	(42.2)
Loss on extinguishment of debt	(39.1)	—	—	—	(39.1)
Other income (expense), net	—	0.1	(0.1)	—	—
Total other expense, net	(81.2)	0.2	(0.3)	—	(81.3)
Income (loss) from continuing operations before income taxes	(93.1)	14.8	6.2	—	(72.1)
Provision (benefit) for income taxes from continuing operations	0.9	1.8	1.0	—	3.7
Income (loss) from continuing operations	(94.0)	13.0	5.2	—	(75.8)
Income (loss) from discontinued operations	0.2	(0.2)	—	—	—
Equity in net income (loss) of subsidiaries	18.0	5.2	—	(23.2)	—
Net income (loss)	$(75.8)	$18.0	$5.2	$(23.2)	$(75.8)
Comprehensive income (loss)	$(76.0)	$18.0	$5.0	$(23.0)	$(76.0)

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Condensed Consolidating Statement of Cash Flows
Nine Months Ended September 29, 2013
(Unaudited)
(in millions)

	Parent Company	Guarantors on a Combined Basis	Non-Guarantors on a Combined Basis	Eliminations	Consolidated
Net cash provided by (used in) operating activities	$(33.4)	$40.7	$3.7	$—	$11.0
Investing activities:					
Cash paid for acquisitions, net of cash acquired	—	2.2	—	—	2.2
Investment in affiliated companies	—	(32.4)	—	32.4	—
(Increase) decrease in restricted cash	—	0.5	—	—	0.5
Capital expenditures	(1.0)	(9.3)	(1.9)	—	(12.2)
Proceeds from sale of discontinued operations	—	0.4	—	—	0.4
Net cash provided by (used in) investing activities from continuing operations	(1.0)	(38.6)	(1.9)	32.4	(9.1)
Financing activities:					
Repayment of debt	—	—	(0.8)	—	(0.8)
Cash paid for contingent acquisition consideration	—	(2.1)	—	—	(2.1)
Financing from affiliated companies	29.6	—	2.8	(32.4)	—
Other, net	1.2	—	—	—	1.2
Net cash provided by (used in) financing activities from continuing operations	30.8	(2.1)	2.0	(32.4)	(1.7)
Net cash flows of continuing operations	(3.6)	—	3.8	—	0.2
Net operating cash flows from discontinued operations	—	0.5	—	—	0.5
Effect of exchange rate changes on cash and cash equivalents	—	—	0.1	—	0.1
Net increase (decrease) in cash and cash equivalents	$(3.6)	$0.5	$3.9	$—	$0.8

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Condensed Consolidating Statement of Cash Flows
Nine Months Ended September 28, 2014
(Unaudited)
(in millions)

	Parent Company	Guarantors on a Combined Basis	Non-Guarantors on a Combined Basis	Eliminations	Consolidated
Net cash provided by (used in) operating activities	$(33.4)	$21.1	$(5.9)	$—	$(18.2)
Investing activities:					
Cash paid for acquisitions, net of cash acquired	—	(2.6)	—	—	(2.6)
Investment in affiliated companies	—	(12.2)	—	12.2	—
(Increase) decrease in restricted cash	—	(0.1)	—	—	(0.1)
Capital expenditures	(0.6)	(8.0)	(0.8)	—	(9.4)
Net cash used in investing activities from continuing operations	(0.6)	(22.9)	(0.8)	12.2	(12.1)
Financing activities:					
Proceeds from issuance of long-term debt	618.5	—	—	—	618.5
Extinguishment of long-term debt	(661.5)	—	—	—	(661.5)
Debt issuance costs	(8.5)	—	—	—	(8.5)
Credit agreement borrowings	41.0	—	—	—	41.0
Repayment of debt	—	—	(0.7)	—	(0.7)
Financings from affiliated companies	12.2	—	—	(12.2)	—
Other, net	3.3	—	—	—	3.3
Net cash provided by (used in) financing activities from continuing operations	5.0	—	(0.7)	(12.2)	(7.9)
Net cash flows of continuing operations	(29.0)	(1.8)	(7.4)	—	(38.2)
Net operating cash flows from discontinued operations	—	(1.2)	—	—	(1.2)
Effect of exchange rate changes on cash and cash equivalents	—	0.1	(0.2)	—	(0.1)
Net increase (decrease) in cash and cash equivalents	$(29.0)	$(2.9)	$(7.6)	$—	$(39.5)

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Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations.

This Quarterly Report on Form 10-Q (this “Quarterly Report”) contains “forward-looking statements” relating to our future financial performance, the market for our services and our expansion plans and opportunities. In some cases, you can identify forward-looking statements by terminology such as “may,” “will,” “should,” “expect,” “plan,” “anticipate,” “believe,” “estimate,” “predict,” “potential,” or “continue,” the negative of such terms or other comparable terminology. These forward-looking statements reflect our current beliefs, expectations and projections, are based on assumptions, and are subject to known and unknown risks and uncertainties that could cause our actual results or achievements to differ materially from any future results or achievements expressed in or implied by our forward-looking statements. Many of these factors are beyond our ability to control or predict. As a result, you should not place undue reliance on forward-looking statements. The most important risks and uncertainties that could cause our actual results or achievements to differ materially from the results or achievements reflected in our forward-looking statements, include, but are not limited to: changes or cutbacks in spending or the appropriation of funding by the federal government, including the U.S. Department of Defense, which could cause delays, cancellations or reductions of key government contracts; changes in the scope or timing of our projects; the timing, rescheduling or cancellation of significant customer contracts and agreements, or consolidation by or the loss of key customers; risks of adverse regulatory action or litigation; risks associated with debt leverage; failure to successfully consummate acquisitions or integrate acquired operations; risks related to security breaches, cybersecurity attacks or other significant disruptions of our information systems; and competition in the marketplace, which could reduce revenues and profit margins, as well as the additional risks and uncertainties described in this Quarterly Report on Form 10-Q and in “Item 1A-Risk Factors” of our Annual Report on Form 10-K for the fiscal year ended December 29, 2013 filed with the Securities and Exchange Commission on March 12, 2014. These forward-looking statements reflect our views and assumptions only as of the date such forward-looking statements are made. Except as required by law, we assume no responsibility for updating any forward-looking statements, whether as a result of new information, future events or otherwise.

All references to “us,” “we,” “our,” the “Company” and “Kratos” refer to Kratos Defense & Security Solutions, Inc., a Delawar corporation, and its subsidiaries.

Overview

We are a specialized security technology business providing mission critical products, technology solutions and services for domestic and international customers, with our principal customers being national security related agencies of the U.S. Government. Our core capabilities are sophisticated engineering, manufacturing, system integration, test and evaluation offerings for national security platforms and programs. Our principal products and services are related to Command, Control, Communications, Computing, Combat Systems, Intelligence, Surveillance and Reconnaissance (“C5ISR”). We offer our customers products, solutions, services and expertise to support their mission-critical needs by leveraging our skills across our core offering areas in C5ISR.

We design, engineer and manufacture specialized electronic components, subsystems and systems for electronic attack, electronic warfare, radar, and missile system platforms; integrated product, software and technology solutions for satellite communications; products and solutions for unmanned systems; products and services related to cybersecurity and cyberwarfare; products and solutions for ballistic missile defense; weapons systems trainers; advanced network engineering and information technology services; weapons systems lifecycle support and sustainment; military weapon range operations and technical services; and public safety, critical infrastructure security and surveillance systems. We believe our stable customer base, strong customer relationships, intellectual property, broad array of contract vehicles, "designed in" positions on strategic national security platforms, large employee base possessing specialized skills, specialized manufacturing facilities and equipment, extensive list of past performance qualifications, and significant management and operational capabilities position us for success.

We were incorporated in the state of New York on December 19, 1994 and began operations in March 1995. We reincorporated in the state of Delaware in 1998. We completed our exit of the commercial wireless industry, began building a national security focused business and changed the Company's name to Kratos Defense & Security Solutions, Inc. in September 2007.

Industry Update

On February 15, 2014, legislation was signed that raises the U.S. debt limit through March 2015. In addition, in January 2014, appropriators passed legislation that offsets a portion of the sequester cuts for fiscal 2014 and 2015. This

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translates to a somewhat better outlook for the defense industry than what was generally expected for both this year and next. However, we still expect lower or delayed awards on some of our programs, increased competition for a reduced defense outlay, and increased protest activity with a related negative impact on our revenues, earnings and cash flows.

In March 2014, the Pentagon submitted its FY 2015 Budget Request of approximately $496 billion, which is consistent with the Bipartisan Budget Spending Authorization. Also in March 2014, the Pentagon published the Quadrennial Defense Review ("QDR"). Both the Pentagon’s FY 2015 Budget Request and the QDR provide important insight for future national security funding priorities and related programs, which include cyber security and warfare, unmanned systems, satellite communications, missile defense and electronic warfare.

In September 2014, the President signed a FY2015 Continuing Resolution ("CR") that will fund the government through December 11, 2014. The bill sets the discretionary funding level for the federal government during CR period at an annual rate of $1.012 trillion. The House has passed seven of the twelve FY2015 appropriations bills while the Senate has passed none to date. As a result, Congress will have less than one month to reach agreement on the details of all 12 appropriations bills, put them together into an omnibus bill, and get the omnibus bill to the president by December 11th. If Congress does not meet this deadline it will need to pass another CR to avert a government shutdown.

Reportable Segments

We operate in two principal reportable business segments: Kratos Government Solutions (“KGS”) and Public Safety & Security (“PSS”). We organize our reportable business segments based on the nature of the products, solutions and services offered. Transactions between segments are generally negotiated and accounted for under terms and conditions similar to other government and commercial contracts, and these intercompany transactions are eliminated in consolidation. The condensed consolidated financial statements in this Form 10-Q are presented in a manner consistent with our operating structure. For additional information regarding our reportable business segments, see Note 9 of the notes to the condensed consolidated financial statements. From a customer and solutions perspective, we view our business as an integrated whole, leveraging skills and assets wherever possible.

Strategic Acquisitions

We have historically supplemented our organic growth by identifying, acquiring and integrating businesses that meet our primary objective of providing us with the technology, intellectual property, manufacturing facilities and production equipment to address strategic national security programs and platforms, primarily in the unmanned systems, electronic warfare, satellite communications and missile system and radar areas of the DoD. We have also made certain acquisitions in the critical infrastructure security, strategic asset protection and public safety areas to expand our capabilities, scope, national depth, breadth and overall service offering.

Key Financial Statement Concepts