

KRATOS DEFENSE & SECURITY SOLUTIONS, INC.
Form 10-Q
May 12, 2009

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**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 MARCH 29, 2009

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

Commission file number 0-27231

KRATOS DEFENSE & SECURITY SOLUTIONS, INC.

(Exact name of Registrant as specified in its charter)

Delaware
(State or other jurisdiction of
incorporation or organization)

13-3818604
(I.R.S. Employer
Identification No.)

**4810 Eastgate Mall
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). o Yes o No

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 (Check one):

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Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company
(Do not check if a smaller reporting company)

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

As of April, 30, 2009 129,873,940 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 MARCH 29, 2009

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Table of Contents**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 28, 2008	March 29, 2009
Assets		
Current assets:		
Cash and cash equivalents	\$ 3.2	\$ 3.2
Restricted cash	0.4	0.4
Accounts receivable, net	100.5	91.5
Income taxes receivable	0.7	1.5
Prepaid expenses	3.6	3.7
Other current assets	7.8	5.4
Total current assets	116.2	105.7
Property and equipment, net	7.2	6.5
Goodwill	152.2	110.2
Other intangibles, net	32.2	30.7
Other assets	4.6	3.5
Total assets	\$ 312.4	\$ 256.6
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	\$ 18.4	\$ 21.2
Accrued expenses	13.5	8.4
Accrued compensation	14.5	15.7
Billings in excess of costs and earnings on uncompleted contracts	9.7	6.1
Current portion of long-term debt	5.9	3.8
Other current liabilities	19.2	12.7
Total current liabilities	81.2	67.9
Long-term debt, net of current portion	76.0	76.7
Other long-term liabilities	8.3	6.9
Total liabilities	165.5	151.5
Commitments and contingencies		
Stockholders' equity:		
Preferred stock, 5,000,000 shares authorized Series B Convertible Preferred Stock, \$.001 par value, 10,000 shares outstanding at December 28, 2008 and March 29, 2009 (liquidation preference \$5.0 million at March 29, 2009)		
Common stock, \$.001 par value, 195,000,000 shares authorized; 128,169,634 and 128,377,442 shares issued and outstanding at December 28, 2008 and March 29, 2009, respectively		

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Additional paid-in capital	503.5	503.8
Accumulated deficit	(356.6)	(398.7)
Total stockholders' equity	146.9	105.1
Total liabilities and stockholders' equity	\$ 312.4	\$ 256.6

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

Table of Contents**KRATOS DEFENSE & SECURITY SOLUTIONS, INC.****CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS****(in millions, except per share amounts)****(Unaudited)**

	Three months ended March 30, 2008	Three months ended March 29, 2009
Revenues	\$ 68.2	\$ 83.9
Cost of revenues	55.6	66.8
Gross profit	12.6	17.1
Selling, general and administrative expenses	11.9	15.0
Research and development expenses		0.4
Impairment of goodwill		41.3
Operating income (loss) from continuing operations	0.7	(39.6)
Other expense:		
Interest expense, net	(2.3)	(2.5)
Other expense, net	(0.4)	
Total other expense, net	(2.7)	(2.5)
Loss from continuing operations before income taxes	(2.0)	(42.1)
Provision for income taxes from continuing operations	0.5	0.3
Loss from continuing operations	(2.5)	(42.4)
Income from discontinued operations	0.6	0.3
Net loss	\$ (1.9)	\$ (42.1)
Basic loss per common share:		
Loss from continuing operations	\$ (0.03)	\$ (0.33)
Income from discontinued operations	0.01	0.00
Net loss per common share:	\$ (0.02)	\$ (0.33)
Diluted loss per common share:		
Loss from continuing operations	\$ (0.03)	\$ (0.33)
Income from discontinued operations	0.01	0.00
Net loss per common share:	\$ (0.02)	\$ (0.33)
Weighted average common shares outstanding:		
Basic	79.0	128.4
Diluted	79.0	128.4

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

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

	Three months ended March 30, 2008	Three months ended March 29, 2009
Operating activities:		
Net loss	\$ (1.9)	\$ (42.1)
Less: Income from discontinued operations	0.6	0.3
Loss from continuing operations	(2.5)	(42.4)
Adjustments to reconcile loss from continuing operations to net cash provided by operating activities from continuing operations:		
Depreciation and amortization	1.8	2.2
Deferred income taxes	0.2	
Goodwill impairment charges		41.3
Asset impairment charges and net loss on disposition of assets	0.1	
Stock-based compensation	0.2	0.4
Mark to market on swaps	0.7	
Change in accrual for unused office space		0.6
Changes in assets and liabilities, net of acquisitions:		
Accounts receivable	(2.4)	9.1
Prepaid expenses and other assets	3.4	2.9
Accounts payable	0.8	2.7
Accrued compensation		1.2
Accrued expenses	(2.5)	(4.9)
Billings in excess of costs and earnings on uncompleted contracts	(1.1)	(3.6)
Income tax receivable and payable	0.5	(0.2)
Other liabilities	2.8	(2.3)
Net cash provided by operating activities from continuing operations	2.0	7.0
Investing activities:		
Cash paid for contingent acquisition consideration		(3.0)
Cash paid for acquisitions, net of cash acquired	(3.0)	(0.5)
Proceeds/(payments) from the disposition of discontinued operations	2.3	(1.1)
Other	(0.6)	(0.1)
Net cash used in investing activities from continuing operations	(1.3)	(4.7)
Financing activities:		
Borrowings under credit facility	2.0	2.0
Repayment under credit facility		(1.3)
Payments of subordinated debt		(2.1)
Other	(0.1)	0.1

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Net cash provided by (used in) financing activities from continuing operations	1.9	(1.3)
Net cash flows of continuing operations	2.6	1.0
Net operating cash flows of discontinued operations	(0.2)	(1.0)
Net increase in cash and cash equivalents	2.4	
Cash and cash equivalents at beginning of period	8.6	3.2
Cash and cash equivalents at end of period	\$ 11.0	\$ 3.2

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

(a)

Basis of Presentation

The information as of March 29, 2009 and for the three months ended March 30, 2008 and March 29, 2009 is unaudited. The condensed consolidated balance sheet as of December 28, 2008 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 of America. 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 year ended December 28, 2008, filed on Form 10-K on March 10, 2009, with the United States Securities and Exchange Commission ("SEC"). 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 consolidated financial statements include the accounts of Kratos and its wholly-owned subsidiaries for which all inter-company transactions have been eliminated in consolidation. Kratos and its subsidiaries are collectively referred to herein as the "Company."

(c)

Fiscal Year

The Company's fiscal year end is on the last Sunday of the year, with interim fiscal periods ending on the last Sunday of the last month of each calendar quarter. There are 52 calendar weeks in the fiscal years ended December 28, 2008 and December 27, 2009.

(d)

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America (US GAAP) 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, 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, accruals for partial self-insurance, contingencies and litigation and contingent acquisition consideration. In the future, the Company may realize actual results that differ from the current reported estimates and if the estimates that we have 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.

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KRATOS DEFENSE & SECURITY SOLUTIONS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Note 1. Summary of Significant Accounting Policies (Continued)

(e)

Revenue Recognition

The Company generates almost all of its revenue from three different types of contractual arrangements: cost-plus-fee contracts, time-and-materials contracts, and fixed-price contracts. Revenue on cost-plus-fee contracts is recognized to the extent of allowable costs incurred plus an estimate of the applicable fees 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 and recognizes the relevant portion of the expected fee to be awarded by the customer at the time such fee can be reasonably estimated, based on factors such as our prior award experience and communications with the customer regarding performance, including any interim performance evaluations rendered by the customer. Revenue on time-and-material contracts is recognized to the extent of billable rates times hours delivered for services provided, to the extent of material cost for products delivered to customers, and to the extent of expenses incurred on behalf of the customers.

The Company has three basic categories of fixed price contracts: fixed unit price, fixed price-level of effort, and fixed price-completion. Revenue recognition methods on fixed-price contracts will vary depending on the nature of the work and the contract terms. Revenues on fixed-price service contracts are recorded as work is performed in accordance with Staff Accounting Bulletin 104 *"Revenue Recognition"* (SAB 104). SAB 104 generally requires revenue to be deferred until all of the following have occurred: (1) there is a contract in place, (2) delivery has occurred, (3) the price is fixed or determinable, and (4) collectibility is reasonably assured. Revenues on fixed-price contracts that require delivery of specific items may be recorded based on a price per unit as units are delivered. Revenue for fixed price contracts in which the Company is paid a specific amount to provide services for a stated period of time is recognized ratably over the service period.

A portion of our fixed price-completion contracts are within the scope of Statement of Position 81-1 *"Accounting for Performance of Construction-Type and Certain Production-Type Contracts"* (SOP 81-1). For these contracts, revenue is recognized using the percentage-of-completion method based on the ratio of total costs incurred to date compared to estimated total costs to complete the contract. Estimates of costs to complete include material, direct labor, overhead, and allowable general and administrative expenses for our government contracts. These cost estimates are reviewed and, if necessary, revised monthly on a contract-by-contract basis. If, as a result of this review, the Company determines that a loss on a contract is probable, then the full amount of estimated loss is charged to operations in the period it is determined that it is probable a loss will be realized from the full performance of the contract. In certain instances in which it is impractical to estimate the final outcome of the project margin, but it is certain that the Company will not incur a loss on the project, the Company may record revenue equal to cost incurred, at zero margin. In the event that the cost incurred to date may be in excess of the funded contract value, the Company may defer those costs until the associated contract value has been funded by the customer. Once the final estimate of the outcome of the project margin is determined, the Company will record revenue using the percentage-of-completion method of accounting based on the ratio of total costs incurred to date compared to the estimated total costs to complete the project.

Significant management judgments and estimates, including but not limited to the estimated costs to complete projects, must be made and used in connection with the revenue recognized in any accounting period. A cancellation, schedule delay, or modification of a fixed-price contract which is

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KRATOS DEFENSE & SECURITY SOLUTIONS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Note 1. Summary of Significant Accounting Policies (Continued)

accounted for using the percentage-of-completion method may adversely affect our gross margins for the period in which the contract is modified or cancelled. Under certain circumstances, a cancellation or negative modification could result in the Company having to reverse revenue that was recognized in a prior period, thus significantly reducing the amount of revenues recognized for the period in which the adjustment is made. Correspondingly, a positive modification may positively affect gross margins. In addition, a schedule delay or modifications can result in an increase in estimated cost to complete the project, which would also result in an impact to gross margins. Material differences may result in the amount and timing of our revenue for any period if management made different judgments or utilized different estimates.

It is the Company's policy to review any arrangement containing software or software deliverables and services against the criteria contained in SOP 97-2, "*Software Revenue Recognition*", and related technical practice aids. Under the provisions of SOP 97-2, the Company reviews the contract value of software deliverables and services and determines allocations of the contract value based on Vendor Specific Objective Evidence ("VSOE") or fair value for each of the elements. All software arrangements requiring significant production, modification, or customization of the software are accounted for in conformity with Accounting Research Bulletin 45 "*Long-Term Construction-Type Contracts*" (ARB 45), using the relevant guidance in SOP 81-1.

The Company's contracts may include the provision of more than one of its services. In these situations, the Company applies the guidance of FASB's Emerging Issues Task Force (EITF) Issue 00-21, "*Revenue Arrangements with Multiple Deliverables*". Accordingly, for applicable arrangements, revenue recognition includes the proper identification of separate units of accounting and the allocation of revenue across all elements based on relative fair values, with proper consideration given to the guidance provided by other authoritative literature.

Under certain of the Company's contractual arrangements, the Company may also recognize revenue for out-of-pocket expenses in accordance with EITF 01-14 "*Income Statement Characterization of Reimbursements Received for Out-of-Pocket Expenses Incurred*." Depending on the contractual arrangement, these expenses may be reimbursed with or without a fee.

Under certain of its contracts, the Company provides supplier procurement services and materials for its customers. The Company records revenue on these arrangements on a gross or net basis in accordance with EITF 99-19, "*Reporting Revenue Gross as a Principal versus Net as an Agent*," depending on the specific circumstances of the arrangement. The Company considers the following criteria, among others, for recording revenue on a gross or net basis:

- (1) Whether the Company acts as a principal in the transaction;
- (2) Whether the Company takes title to the products;
- (3) Whether the Company assumes risks and rewards of ownership, such as risk of loss for collection, delivery or returns;
- (4) Whether the Company serves as an agent or broker, with compensation on a commission or fee basis; and

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KRATOS DEFENSE & SECURITY SOLUTIONS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Note 1. Summary of Significant Accounting Policies (Continued)

(5) Whether the Company assumes the credit risk for the amount billed to the customer subsequent to delivery.

For federal contracts, the Company follows U.S. government procurement and accounting standards in assessing the allowability and the allocability of costs to contracts. Due to the significance of the judgments and estimation processes, it is likely that materially different amounts could be recorded if different assumptions were used or if the underlying circumstances were to change. The Company closely monitors compliance with, and the consistent application of, its critical accounting policies related to contract accounting. Business operations personnel conduct periodic contract status and performance reviews. When adjustments in estimated contract revenues or costs are required, any significant changes from prior estimates are included in earnings in the current period. 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. Costs incurred and allocated to contracts with the U.S. government are scrutinized for compliance with regulatory standards by the Company's personnel, and are subject to audit by the Defense Contract Audit Agency (DCAA).

From time to time, the Company may proceed with work based on client direction prior to the completion and signing of formal contract documents. The Company has a formal review process for approving any such work. Revenue associated with such work is recognized only when it can be reliably estimated and realization is probable. The Company bases its estimates on previous experiences with the client, communications with the client regarding funding status, and its knowledge of available funding for the contract or program. As December 28, 2008 and March 29, 2009 approximately \$0.8 million and \$0.6 million, respectively, of the Company's unbilled accounts receivable balance were under an authorization to proceed or work order from its customers where a formal purchase order had not yet been received.

(f)

Cash and Cash Equivalents

The Company has restricted cash accounts of approximately \$0.4 million as of December 28, 2008, and March 29, 2009, which are required to collateralize a credit card program and a deposit relating to the run out of a now terminated workers compensation program.

(g)

Inventory

Inventories which are comprised primarily of supplies including parts and materials are stated at the lower of cost or market. The Company regularly reviews inventory quantities on hand, future purchase commitments with its suppliers, and the estimated utility of its inventory. If the Company review indicates a reduction in utility below carrying value, it reduces its inventory to a new cost basis. As of December 28, 2008 and March 29, 2009, the Company had \$2.1 million of inventories which were reflected in other current assets on the condensed consolidated balance sheets.

(h)

Liquidity

The Company currently carries a significant amount of debt and has historically experienced recurring losses and negative cash flows from continuing operations. Given the Company's highly

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KRATOS DEFENSE & SECURITY SOLUTIONS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Note 1. Summary of Significant Accounting Policies (Continued)

leveraged liquidity position, any down-turn in its operating earnings or cash flows could impair its ability to comply with the financial covenants of its existing credit facility. Its ability to execute on additional business opportunities may be limited due to its existing borrowing capacity. If the Company believed a covenant violation is more than likely to occur in the near future, it would seek relief from its lenders. This relief, if available, would have some cost to the Company and such relief might not be on terms as favorable as those in its existing Credit Agreement. If the Company were to actually default due to its failure to meet the financial covenants of its Credit Agreement and inability to obtain a waiver from the lenders, the Company's Credit Agreement could require the Company to immediately repay all amounts then outstanding under the Credit Agreement and/or require the Company to pay interest at default rates per the Credit Agreement. In the event the Company was required to repay the amount outstanding under the existing credit facility, it would need to obtain alternative sources of financing to continue its operating activities at existing levels. There can be no assurance that alternative financing would be available on acceptable terms or at all.

(i)

Recent Accounting Pronouncements

Adoption of New Accounting Standards

The disclosure requirements of SFAS No. 157 *Fair Value Measurements*, which took effect on January 1, 2008, are presented in Note 9. On January 1, 2009, the Company implemented the previously deferred provisions of SFAS No. 157 for nonfinancial assets and liabilities recorded at fair value, as required.

The disclosure requirements of SFAS No. 161 *Disclosures about Derivative Instruments and Hedging Activities*, which took effect on January 1, 2009, are presented in Note 10.

The accounting requirements of SFAS No. 141(R) *Business Combinations*, which took effect on January 1, 2009, were adopted but had no impact on the Company's consolidated financial statements.

The accounting and presentation requirements of SFAS No. 160 *Noncontrolling Interests in Consolidated Financial Statements an amendment of Accounting Research Bulletin No. 51*, which took effect on January 1, 2009, had no impact on the financial statements as the Company's non-controlling interests were not material.

Standards Issued But Not Yet Effective

Other new pronouncements issued but not effective until after March 31, 2009, are not expected to have a significant effect on the company's consolidated financial position or results of operations.

Note 2. Goodwill and Other Intangible Assets

Goodwill

The Company performs its annual impairment test for goodwill in accordance with SFAS 142, *Goodwill and Other Intangible Assets* as of the last day of the fiscal year or when evidence of potential impairment exists. The Company's testing approach utilizes a discounted cash flow analysis corroborated by comparative market multiples to determine the fair value of its businesses for

Table of Contents**KRATOS DEFENSE & SECURITY SOLUTIONS, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)****Note 2. Goodwill and Other Intangible Assets (Continued)**

comparison to their corresponding book values because there are no observable inputs available (Level 3 hierarchy as defined by SFAS 157, *Fair Value Measurements*). If the book value exceeds the estimated fair value for a business, a potential impairment is indicated and SFAS 142 prescribes the approach for determining the impairment amount, if any.

Given the continued significant decline in the stock market in general and specifically the Company's stock price in 2009, the Company performed an impairment test for goodwill in accordance with SFAS 142 as of February 28, 2009. The test indicated that the book value for the Kratos Government Solutions (KGS) segment exceeded the fair values of these businesses and resulted in the Company recording a charge totaling \$41.3 million in its KGS segment for the impairment of goodwill. The impairment charge is primarily driven by adverse equity market conditions that caused a decrease in current market multiples and the Company's average stock price as of February 28, 2009, compared with the test performed as of December 28, 2008.

The Company will continue to evaluate whether a triggering event under SFAS 142 that could be an indication of additional goodwill impairment occurs. If such a triggering event is identified, the Company will perform additional goodwill impairment tests.

The following tables summarize the changes in the carrying amounts of goodwill and other finite-life intangible assets for the three months ended March 29, 2009 (in millions):

	Government Solutions
Goodwill	
Balance as of December 28, 2008	\$ 152.2
Impairments	(41.3)
Purchase accounting adjustments	(0.7)
Balance as of March 29, 2009	\$ 110.2

Purchased Intangible Assets

The following tables set forth information for finite-lived intangible assets subject to amortization (in millions):

	As of December 28, 2008			As of March 29, 2009		
	Gross Value	Accumulated Amortization	Net Value	Gross Value	Accumulated Amortization	Net Value
Acquired finite-lived intangible assets						
Customer relationships	\$23.0	\$ (5.0)	\$18.0	\$23.0	\$ (5.8)	\$17.2
Contracts and backlog	17.1	(6.6)	10.5	17.1	(7.3)	9.8
Developed technology	3.1	(0.2)	2.9	3.1	(0.2)	2.9
Non-compete agreements	1.3	(1.3)	0.0	1.3	(1.3)	0.0
Trade names	1.2	(0.4)	0.8	1.2	(0.4)	0.8
Total	\$45.7	\$ (13.5)	\$32.2	\$45.7	\$ (15.0)	\$30.7

Consolidated amortization expense related to intangible assets subject to amortization was \$1.2 million and \$1.5 million for the quarters ended March 30, 2008 and March 29, 2009, respectively.

Table of Contents**KRATOS DEFENSE & SECURITY SOLUTIONS, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)****Note 3. Stockholders' Equity**

The Company had the following equity incentive plans under which shares were available for grant at March 29, 2009: the 1999 Equity Incentive Plan (the "1999 Plan"), the 2000 Non-Statutory Stock Option Plan (the "2000 Plan") and the 2005 Equity Incentive Plan (the "2005 Plan").

Digital Fusion, Inc. 1998, 1999, 2000, and 2005 Stock Option and Stock Incentive Plans.

In connection with the Company's acquisition of Digital Fusion, Inc. (DFI) on December 24, 2008, the Company assumed all outstanding options under DFI's 1998, 1999, 2000, and 2005 Stock Option and Stock Incentive Plans. No further grants will be made under these plans. Award grants that were outstanding under these plans on December 24, 2008 will continue to be governed by their existing terms and may be exercised for shares of the Company's common stock at any time prior to the expiration of the option pursuant to its terms. Stock options granted under these plans included incentive stock options and non-statutory stock options. All non-statutory options vest upon change in control and were 100% vested on December 24, 2008. With respect to incentive stock options, the qualified stock option plans provide that the exercise price of each such option must be at least equal to 100% of the fair market value of its common stock on the date of grant. Stock options granted under these plans may generally be exercised from one to ten years after the date of grant. Certain of these options had change in control provisions that extended the exercise period for grants for two years from the transaction closing date. Awards granted under these plans generally vest equally over three years; however, in connection with the Company's acquisition of DFI the plans were amended to include immediate vesting of all unvested grants upon any future change in control of the Company. DFI also granted certain options outside of its qualified stock option plans. These non-qualified "out of plan" stock options have been assumed by the Company and expire 10 years from the grant date.

The Company also has a form of Restricted Stock Unit Agreement (the "RSU Agreement") to govern the issuance of restricted stock units ("RSU") to executive officers under the Company's 2005 Plan.

The following table summarizes the Company's Restricted Stock Unit activity:

	Restricted Stock Units (000's)	Weighted- Average Grant-Date Fair Value
Nonvested balance, December 28, 2008	2,843	\$ 2.21
Grants	1,775	\$ 1.40
Vested	(58)	\$ 2.11
Cancellations/Forfeitures	(64)	\$ 1.75
Nonvested balance March 29, 2009	4,496	\$ 1.59

The following table shows the amounts recognized in the financial statements for the three months ended March 30, 2008 and March 29, 2009 for stock-based compensation expense related to employees (in millions, except per share data). The stock-based compensation expense for the three months ended March 30, 2008 and March 29, 2009 primarily relates to the grant of restricted stock units. In addition,

Table of Contents**KRATOS DEFENSE & SECURITY SOLUTIONS, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)****Note 3. Stockholders' Equity (Continued)**

for the three months ended March 30, 2008 and March 29, 2009, there was no incremental tax benefit from stock options exercised in the period.

	Three Months Ended March 30, 2008	Three Months Ended March 29, 2009
Selling, general and administrative	\$ 0.2	\$ 0.4
Total cost of employee stock-based compensation included in operating loss from continuing operations, before income tax	0.2	0.4
Amount charged to loss from discontinued operations	0.0	
Total charged against operations	\$ 0.2	\$ 0.4
Impact on net loss per common share:		
Basic	\$ (0.00)	\$ (0.00)
Diluted	\$ (0.00)	\$ (0.00)

In August 1999, the Board of Directors approved the 1999 Employee Stock Purchase Plan (the "Purchase Plan"). A total of 4.4 million shares of common stock have been authorized for issuance under the Purchase Plan. The Purchase Plan qualifies as an employee stock purchase plan within the meaning of Section 423 of the Internal Revenue Service Code. The Purchase Plan commenced in November 1999 upon completion of the Company's initial public offering. On November 16, 2005, the Compensation Committee of the Board of Directors elected to suspend all future offerings under the Purchase Plan effective January 1, 2006. On February 27, 2008, the Compensation Committee elected to reinstate offerings under the Purchase Plan effective April 1, 2008.

Employees who actively participate in the Purchase Plan are eligible to have up to 15% of their earnings for each purchase period withheld pursuant to the Purchase Plan. The amount that was withheld was used at various purchase dates within the offering period to purchase shares of common stock. The price paid for common stock at each such purchase date is equal to the lower of 85% of the fair market value of the common stock at the commencement date of that offering period or 85% of the fair market value of the common stock on the relevant purchase date. Employees are also able to end their participation in the offering at any time during the offering period, and participation ends automatically upon termination of employment. For the three month period ended March 29, 2009, 0.2 million shares were purchased with a total value of \$0.2 million. No shares were purchased under the plan for the quarter ended March 30, 2008.

Table of Contents**KRATOS DEFENSE & SECURITY SOLUTIONS, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)****Note 3. Stockholders' Equity (Continued)**

A summary of the changes in Stockholders' Equity for the quarters ended March 30, 2008 and March 29, 2009 is provided below (in millions):

	Three Months Ended March 30, 2008	Three Months Ended March 29, 2009
Stockholders' equity, beginning of period	\$ 167.2	\$ 146.9
Stock-based compensation	0.2	0.4
Working capital adjustment for Haverstick acquisition	1.3	(0.2)
ESPP Plan and RSU settlement in cash		0.1
Additional paid-in-capital for acquisition	0.4	
Net loss	(1.9)	(42.1)
Stockholders' equity, end of period	\$ 167.2	\$ 105.1

The Company has two classes of stock, Series B Convertible Preferred Stock and common stock. There was no issuance, redemption or conversion of the Series B Convertible Preferred Stock in the quarter ended March 30, 2008 or for the quarter ended March 29, 2009. Common stock issued by the Company for the three months ended March 30, 2008, and March 29, 2009, was as follows (in millions):

	Three Months Ended March 30, 2008	Three Months Ended March 29, 2009
Shares outstanding at the beginning of the period	79.0	128.2
Stock issued for employee stock purchase plan		0.2
Shares outstanding at the end of the period	79.0	128.4

Note 4. Net Income (Loss) Per Common Share

The Company calculates net income (loss) per share in accordance with SFAS No. 128, *Earnings Per Share*. Under SFAS 128, 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 (in millions).

	March 30, 2008	March 29, 2009
Weighted average shares excluded from the calculation of diluted earnings per share because they are antidilutive		
Weighted shares from restricted stock units and stock options	8.9	2.0
Weighted shares from preferred stock	1.0	1.0
Weighted shares of common stock contingently issuable	2.9	2.9
Weighted shares of common stock from convertible debt		0.9

Table of Contents**KRATOS DEFENSE & SECURITY SOLUTIONS, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)****Note 5. Income Taxes**

As of December 28, 2008, the Company had \$12.8 million of unrecognized tax benefits. During the first quarter of 2009, this amount was reduced by \$0.3 million relating to the expiration of statutes of limitations resulting in unrecognized tax benefits at March 29, 2009 of \$12.5 million. The reduction in unrecognized tax benefits was recorded as a tax benefit from discontinued operations for \$0.3 million.

The Company recognizes interest and penalties related to unrecognized tax benefits in its provision for income taxes. There were no material amounts recorded during the periods ended March 30, 2008 and March 29, 2009.

The Company believes that it is reasonably possible that as much as \$3.4 million of the FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (FIN 48) tax liabilities will expire within 12 months of March 29, 2009 due to the expiration of various applicable statutes of limitations and possible settlement of a pending income tax refund claim.

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

In assessing the realizability of 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 its deferred tax assets, with the exception of an amount equal to its deferred tax liabilities which can be expected to reverse. Management will continue to evaluate the necessity to maintain a valuation allowance against its net deferred tax asset.

A reconciliation of total income tax provision to the amount computed by applying the statutory federal income tax rate of 35% to loss from continuing operations before income tax provision for the three months ended March 30, 2008 and March 29, 2009 is as follows (in millions):

	March 30, 2008	March 29,2009
Income tax expense (benefit) at federal statutory rate	\$ (0.7)	\$ (14.7)
State taxes, net of federal tax benefit and valuation allowance	0.3	0.3
Nondeductable goodwill impairment charges		14.6
Nondeductable expenses	0.1	
Increase (decrease) in federal valuation allowance	0.8	0.1
Total	\$ 0.5	\$ 0.3

Table of Contents**KRATOS DEFENSE & SECURITY SOLUTIONS, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)****Note 6. Acquisitions***Digital Fusion, Inc.*

On December 24, 2008, the Company acquired Huntsville, Alabama based Digital Fusion, Inc. (DFI) in a stock for stock transaction for approximately \$37.0 million. DFI provides Command, Control, Communications, Computing, Intelligence, Surveillance, and Reconnaissance (C4ISR) and technical engineering services, Unmanned Aerial Vehicle (UAV) products and technology and has significant engineering, modeling and simulation capabilities. The acquisition of DFI provides Kratos with new customers and an expanded contract vehicle portfolio, in addition to expanding the range of service offerings to existing Kratos customers. Principal customers of DFI include the Army Aviation and Missile Research, Development and Engineering Center (AMRDEC), Army Space and Missile Defense Command/Army Forces Strategic Command ARSTRAT), NASA Marshall Space Flight Center, and certain classified customers. The aforementioned factors are the primary reason for the acquisition and the amount subsequently assigned to goodwill.

The purchase price of \$37.0 million includes direct transaction costs of \$0.9 million. The Company issued 22.9 million shares to DFI shareholders and assumed DFI options which are now exercisable for approximately 10.0 million shares of Kratos common stock. The value of the purchase price related to the common stock issued was derived from the number of shares of Kratos common stock issued of 22.9 million, based on 12.8 million shares of DFI common stock outstanding and the exchange ratio of 1.7933 for each DFI share, at a price of \$1.27 per share, the average closing price of Kratos shares of common stock on the announcement date and for the two days prior to and two days subsequent to the public announcement of the merger on November 24, 2008. The Company assumed DFI options valued at the exchange ratio of 1.7933 for each DFI option. The fair value of the options issued that was allocated to goodwill based upon the Black-Scholes pricing model was \$7.0 million. The fair value of unvested options which are related to future service will be expensed as the service is performed over the weighted average vesting period of 1.2 years. The results of operations of DFI are included in the accompanying condensed consolidated financial statements for the three months ended March 29, 2009.

The following summarizes the allocation of the purchase price, including transaction costs of \$0.9 million, to the fair value of the assets acquired and liabilities assumed at the date of acquisition (in millions):

Cash	\$ 2.3
Accounts receivable, net	10.0
Other current assets	0.1
Property, plant, and equipment	1.0
Intangible assets	9.3
Goodwill	23.8
Other assets	0.4
Total assets	46.9
Current liabilities	(9.0)
Other liabilities	(0.9)
Net assets acquired	\$37.0

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KRATOS DEFENSE & SECURITY SOLUTIONS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Note 6. Acquisitions (Continued)

The goodwill recorded in this transaction is not tax deductible with the exception of approximately \$3.6 million which was tax deductible to DFI.

SYS Technologies

On June 28, 2008, the Company acquired San Diego-based SYS Technologies (SYS). SYS provides a range of C4ISR and net-centric solutions to federal, state, local and other customers. The combination of SYS and Kratos creates a broad, complementary set of offerings, and positions the organization to deliver proven capabilities to a wider spectrum of customers in the areas of highly-specialized engineering and IT solutions and services, specifically in the areas of weapon systems life cycle support and extension, military range operations, missile and weapon system testing, and C4ISR. The amount of goodwill assigned in the allocation of purchase price is primarily attributable to the aforementioned advantages of this acquisition.

The purchase price of \$55.9 million includes direct transaction costs of \$2.4 million and estimated restructuring costs to be paid by Kratos. The value of the purchase price related to the common stock issued was derived from the number of shares of Kratos common stock issued of 25.3 million, based on 20.1 million shares of SYS common stock outstanding and the exchange ratio of 1.2582 for each SYS share, at a price of \$2.022 per share, the average closing price of Kratos shares of common stock on the announcement date and for the two days prior to and two days subsequent to the public announcement of the merger on February 21, 2008. Following the closing of the acquisition, the Company implemented a plan to restructure and/or exit certain business activities of SYS. The plan included a comprehensive assessment of personnel, relocation of personnel, facility consolidation and exit strategies for certain lines of business. The plan provided for approximately \$2.0 million of restructuring costs associated with personnel, and additional costs of \$0.5 million for facilities consolidation. The restructuring costs are primarily associated with the businesses sold and are accounted for in discontinued operations in the accompanying condensed consolidated financial statements.

In addition, the Company identified three business units of SYS that were not core to its business strategy and/or have been dilutive to profitability. The divestiture of these businesses will slightly reduce revenues going forward, and the Company believes will immediately increase profitability and cash flow. The sale of these businesses was completed in the quarter ended March 29, 2009 for an aggregate cash consideration of approximately \$0.4 million. These businesses have been classified as discontinued operations as of December 28, 2008 and March 29, 2009.

The results of operations of SYS are included in the accompanying condensed consolidated financial statements for the three months ended March 29, 2009.

Table of Contents**KRATOS DEFENSE & SECURITY SOLUTIONS, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)****Note 6. Acquisitions (Continued)**

The following summarizes the allocation of the purchase price, including transaction costs of \$2.4 million, to the fair value of the assets acquired and liabilities assumed at the date of acquisition (in millions):

Cash	\$ 4.0
Accounts receivable, net	13.6
Other current assets	1.7
Property, plant, and equipment	1.4
Intangible assets	8.9
Goodwill	40.1
Other assets	0.2
Total assets	69.9
Current liabilities	(13.2)
Other liabilities	(0.8)
Net assets acquired	\$ 55.9

The goodwill recorded in this transaction is not tax deductible with the exception of approximately \$6.7 million which was tax deductible to SYS.

Unaudited Pro Forma Financial Information

The following tables summarize the supplemental statement of operations information on an unaudited pro forma basis as if the acquisitions of SYS and DFI had occurred on January 1, 2008, and includes adjustments that were directly attributable to the transactions or were not expected to have a continuing impact on the Company. The pro forma results are for illustrative purposes only for the applicable period and do not purport to be indicative of the actual results which would have occurred had the transaction been completed as of the beginning of the period, nor are they indicative of results of operations which may occur in the future (all amounts, except per share amounts are in millions):

	Three Months Ended March 30, 2008 As Reported	SYS Pro forma Adjustments	DFI Pro forma Adjustments	Three Months Ended March 30, 2008 Pro forma
Pro forma revenues	\$ 68.2	\$ 17.3	\$ 13.2	\$ 98.7
Pro forma net loss	\$ (1.9)	\$ 1.1	\$ (0.1)	\$ (0.9)
Shares outstanding or issued for acquisition	79.0	25.3	22.9	127.2
Basic and diluted pro forma net loss per share	\$ (0.02)			\$ (0.01)

Contingent Acquisition Consideration

In connection with two prior business acquisitions, Madison Research Corporation (MRC) and Haverstick Consulting, Inc. (Haverstick), the Company has agreed to make additional future payments to sellers contingent upon achievement of specific performance-based milestones by the acquired entities. Pursuant to the provisions of SFAS 141, *Business Combinations* (SFAS 141) such amounts are

Table of Contents**KRATOS DEFENSE & SECURITY SOLUTIONS, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)****Note 6. Acquisitions (Continued)**

accrued, and therefore, recorded by the Company when the contingency is resolved beyond a reasonable doubt and the additional consideration becomes payable.

The Company resolved all outstanding indemnification obligations related to the MRD holdback and made the final payment of \$2.4 million in March 2009. The Company also agreed to make the Haverstick holdback payment related to the December 2008 payment. The stock portion of this payment of 1.4 million shares was not issued until March 31, 2009. The other current liabilities on the accompanying condensed consolidated balance sheet as of March 29, 2009 include \$0.6 million for the final Haverstick cash holdback and the Haverstick common stock holdback consideration of \$8.5 million is reflected as additional paid in capital for contingent consideration in the accompanying condensed consolidated financial statements.

A summary of the contingent acquisition consideration as of December 28, 2008 and March 29, 2009 is summarized in the following table (in millions):

	Haverstick	MRD	Total
Balance as of December 28, 2008	\$ 10.0	\$ 2.5	\$ 12.5
Principal and interest cash payments	(0.6)	(2.4)	(3.0)
Post acquisition adjustments and interest accruals, net	(0.3)	(0.1)	(0.4)
Balance as of March 29, 2009	\$ 9.1	\$	\$ 9.1

Note 7. Discontinued Operations

On July 7, 2007, the Company entered into a definitive agreement with an affiliate of Platinum Equity to sell the Company's wireless deployment business. Platinum Equity is a Los Angeles based private equity firm whose portfolio includes service and distribution businesses in a number of equity sectors. The total consideration for the acquisition was \$24.0 million including \$18.0 million in cash at closing, subject to post closing working capital adjustments, and an aggregate \$6.0 million in a three-year earn-out arrangement through 2010. The transaction included a Transition Services Agreement for the transition of certain services for a period of nine months. The assets sold to an affiliate of Platinum Equity included all of the Company's wireless deployment business, and the Wireless Facilities name. The transaction closed on July 24, 2007.

On September 25, 2007, in accordance with the acquisition agreement, the Company provided its working capital calculation to Platinum Equity. On July 16, 2008, the Company came to an agreement with Platinum Equity on a working capital adjustment of \$5.0 million. In connection with that resolution, the earn-out arrangement was terminated. The adjustment was to be paid in installments with the first amount of \$2.5 million due on July 31, 2008 and payments of \$0.5 million monthly thereafter until paid in full in December 2008. The Company did not make the scheduled \$2.5 million payment due as of July 31, 2008. Payments of \$1.0 million were made in August and September of 2008, with an additional \$0.5 million paid in December 2008. In March of 2009, the Company paid \$1.5 million of the working capital adjustment. As of March 29, 2009, the balance of \$1.0 million plus accrued interest on the outstanding balance has been reflected in other current liabilities.

Table of Contents**KRATOS DEFENSE & SECURITY SOLUTIONS, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)****Note 7. Discontinued Operations (Continued)**

During the due diligence process related to the acquisition of SYS, senior management identified three business units of SYS which were non-core to Kratos' base national security and public security businesses. These businesses provided video surveillance and information analysis products, digital broadcasting products and incident response management systems. In December of 2008, after evaluating these businesses further, a decision was made to dispose of and sell all three business units. In accordance with SFAS 144, *Accounting for the Impairment or Disposal of Long-Lived Assets* (SFAS144), these business units were classified as held for sale and reported in discontinued operations as of and for the year ended December 28, 2008, and the three months ended March 29, 2009, respectively. The Company recorded a \$4.5 million impairment charge in the fourth quarter of 2008 primarily related to the impairment of goodwill and intangibles allocated to these businesses. In the first quarter of 2009, all three of the businesses were sold for an aggregate cash consideration of approximately \$0.4 million.

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

	Three Months Ended March 30, 2008	Three Months Ended March 29, 2009
Revenue	\$	\$ 0.4
Loss before taxes	(0.5)	(0.2)
Benefit for income taxes	(1.1)	(0.5)
Net income	\$ 0.6	\$ 0.3

Following is a summary of the assets and liabilities of discontinued operations as of December 28, 2008 and March 29, 2009 (in millions):

	December 28, 2008	March 29, 2009
Cash	\$ 0.1	\$ 0.1
Accounts receivable, net	0.4	
Other current assets	0.4	0.1
Current assets of discontinued operations	\$ 0.9	\$ 0.2
Non-current assets of discontinued operations	\$ 0.3	\$ 0.3
Accounts payable	\$ 0.1	\$ 0.1
Accrued expenses	4.1	3.2
Unrecognized tax benefits	0.8	1.0
Other current liabilities	0.3	0.3
Current liabilities of discontinued operations	\$ 5.3	\$ 4.6
Non-current unrecognized tax benefits	\$ 1.1	\$ 0.4
Other non-current liabilities	0.8	0.6
Non-current liabilities of discontinued operations	\$ 1.9	\$ 1.0

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KRATOS DEFENSE & SECURITY SOLUTIONS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Note 8. Debt

(a)

Credit Agreement

The Company has a credit facility of \$85.0 million with KeyBanc Capital Markets. This credit facility provides for two term loans consisting of a first lien term note of \$50.0 million and a second lien term note of \$10.0 million, as well as a first lien \$25.0 million revolving line of credit and is collateralized by the assets of the Company. The \$10.0 million term loan has a five and one half-year term with principal payments of \$25.0 thousand required quarterly beginning on March 31, 2008 through March 31, 2013 with the final balance of \$9.5 million due on June 30, 2013. The \$50.0 million term loan has a five year term with principal payments of \$0.6 million required quarterly beginning on March 31, 2008, \$1.3 million in 2009, \$2.5 million in 2010, and \$4.1 million in 2011 and 2012. The term loans have a provision which states that once the full amount of the note has been borrowed, the notes cannot be paid down and reborrowed again. The revolving line of credit has a four year term which expires on December 31, 2011. All loans under the credit facility have an interest rate equal to a base rate defined as a fluctuating rate per annum equal to the higher of (a) the Federal Funds Rate plus 0.5% and (b) the rate of interest in effect for such day as publicly announced from time to time by KeyBank as its "prime rate" plus a margin for the term loans of 6.5% to 7.5% and a margin of 1.0% to 3.25% on the revolving line of credit. All rates are subject to a LIBOR floor of 4.25% and a "prime rate" floor of 5.25%.

As of March 29, 2009, the Company's outstanding balance on the facility was \$79.5 million and the weighted average interest rate on the debt as of March 29, 2009 was 10.56%. As of March 29, 2009, the unused line of credit under the revolving line of credit, net of \$1.5 million in outstanding letters of credit, was approximately \$0.1 million. The only restriction on the use of these funds is that the Company must be in compliance with covenants of the credit facility. The Company was in compliance with all covenants under the credit facility as of March 29, 2009.

(b)

Subordinated Notes

As of December 28, 2008, the Company had outstanding convertible notes payable totaling \$3.1 million which were acquired as a result of the SYS acquisition, of which \$0.8 million was payable to related parties. The convertible notes payable are unsecured and subordinated to the Company's bank debt and bear interest at 10% per annum payable quarterly. Principal was due February 14, 2009 and the notes were convertible at any time into shares of common stock at a conversion rate of \$2.86 per share. In February 2009, in the interest of preserving cash due to the current macroeconomic conditions, the Company provided each note holder with the option to:

- (1) be paid cash in accordance with the original agreement;
- (2) extend the note for an additional 18 months at the existing 10% rate and modify the conversion feature to the lower of the existing conversion price of \$2.86 per share or the Kratos closing share value on February 13, 2009; or
- (3) convert the principal balance of Kratos shares at the lower of the existing conversion price of \$2.86 or the Kratos closing share value on February 13, 2009 less a 10% discount.

As of March 29, 2009, \$2.1 million of the notes had been paid and \$1.0 million of the notes had been extended to August 14, 2010, \$25,000 of which is payable to a related party. The balance of the

Table of Contents**KRATOS DEFENSE & SECURITY SOLUTIONS, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)****Note 8. Debt (Continued)**

outstanding notes of \$1.0 million, which is potentially convertible into common stock of Kratos at \$1.02 per share or approximately 968,000 shares, is reflected in long-term debt in the accompanying condensed consolidated balance sheets.

Interest expense on the convertible notes was approximately \$60,000 for the three month period ended March 29, 2009.

Note 9. Fair Value Measurement

SFAS 157, *Fair Value Measurements* (SFAS 157) defines fair value, establishes a market-based framework or hierarchy for measuring fair value, and expands disclosures about fair value measurements. SFAS 157 is applicable whenever another accounting pronouncement requires or permits assets and liabilities to be measured at fair value, but does not require any new fair value measurements.

The fair value hierarchy established in SFAS 157 prioritizes the inputs used in valuation techniques into three levels as follows:

Level 1 Observable inputs quoted prices in active markets for identical assets and liabilities;

Level 2 Observable inputs other than the quoted prices in active markets for identical assets and liabilities includes quoted prices for similar instruments, quoted prices for identical or similar instruments in inactive markets, and amounts derived from valuation models where all significant inputs are observable in active markets; and

Level 3 Unobservable inputs includes amounts derived from valuation models where one or more significant inputs are unobservable and require the Company to develop relevant assumptions.

The following table presents assets and liabilities measured and recorded at fair value on the Company's balance sheet on a recurring basis and their level within the fair value hierarchy as of March 29, 2009:

	Total Carrying Value March 29, 2009	Quoted prices in active markets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
Derivative liabilities (interest rates swaps)	\$ 1.7	\$	\$ 1.7	\$

The significant Level 2 observable inputs utilized to value the Company's derivative financial instruments are based upon calculations provided by an investment advisor and is validated with the use of a nationally recognized financial reporting service.

Note 10. Derivatives

In the first quarter of 2009, the Company adopted SFAS 161, *Disclosures about Derivative Instruments and Hedging Activities - an amendment of FASB Statement No. 133* (SFAS 161), which requires enhanced qualitative disclosures about the Company's objectives and strategies for using derivatives and quantitative disclosures about the fair value amounts of gains and losses on derivative instruments.

Table of Contents**KRATOS DEFENSE & SECURITY SOLUTIONS, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)****Note 10. Derivatives (Continued)**

The Company uses derivative financial instruments, in particular, interest rate swaps, to reduce the Company's exposure to its variable rate debt. The primary objective of the interest rate swaps is to eliminate the variability of cash flows and interest rate risk for payments made on variable rate debt, the sole source of which is due to changes in the benchmark three month LIBOR interest rate. Changes in the cash flows of the interest rate swap are expected to exactly offset the changes in cash flows (i.e., changes in interest rate payments) attributable to fluctuations in the three month LIBOR on the variable-rate debt.

The Company records derivatives at their fair value. The classification of gains and losses resulting from changes in the fair values of derivatives is dependent on the Company's intended use of the derivative and its resulting designation. Adjustments to reflect changes in fair values of derivatives that the Company consider highly effective hedges are either reflected in earnings and largely offset by corresponding adjustments to the hedged items, or reflected net of income taxes in accumulated other comprehensive income (loss) until the hedged transaction is recognized in earnings, to the extent these derivatives are effective hedges. Changes in the fair value of these derivatives that are attributable to the ineffective portion of the hedges, or of derivatives that are not considered to be highly effective hedges, if any, are immediately recognized in earnings. The aggregate notional amount of outstanding interest rate swap contracts at March 29, 2009 was \$65.0 million.

The Company's derivative financial instruments, which are cash flow hedges, were considered ineffective as a result of the interest rate floor that occurred with the first amendment of the Company's credit facility in March 2008. The effect of marking the derivative instruments to market for the three months ended March 30, 2008 and March 29, 2009 was an expense of \$0.7 million and \$0.0 million, respectively, and is reflected in other expenses in the accompanying condensed consolidated statements of operations. The fair value of the Company's derivative liabilities as of March 28, 2008 and March 29, 2009 was \$0.7 million and \$1.7 million, respectively, and is carried in other long-term liabilities in the accompanying condensed consolidated balance sheets. See Note 9 for further discussion on the fair value measurements related to the Company's derivative instruments.

Note 11. Significant Customers

The following table presents our key customers for the periods presented and the percentage of net sales made to such customers (in millions):

Key Customers	Three Months Ended		Three Months Ended			
	March 30, 2008		March 29, 2009			
U.S. Navy	\$	25.9	30.9%	\$	24.3	34.2%
U.S. Army	\$	18.4	21.9%	\$	18.3	25.7%

The customers are all part of the Kratos Government Services segment. The Company's top five customers accounted for approximately 65.0% and 73.8% of total revenue for the three months ended March 30, 2008 and March 29, 2009, respectively. Total revenue from the federal government for the quarter ended March 29, 2009 was \$71.4 million.

Table of Contents**KRATOS DEFENSE & SECURITY SOLUTIONS, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)****Note 12. Segment Information**

The Company operates in two principal business segments: Kratos Government Solutions (KGS) and Public Safety and Security (PSS). The Company organizes its business segments based on the nature of the services offered. In the following table, total operating income of the business segments is reconciled to the corresponding consolidated amount. The reconciling item "Unallocated Corporate income (expense), net" includes costs for certain stock-based compensation programs (including stock-based compensation costs for stock options and restricted stock units), the effects of items not considered part of management's evaluation of segment operating performance, 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; however, these intercompany transactions are eliminated in consolidation and for purposes of presentation of revenue in the related table that follows.

Revenues and operating income generated by the Company's current reporting segments for the three months ended March 30, 2008 and March 29, 2009 are as follows (in millions):

	Three Months Ended March 30, 2008 and March 29, 2009	
	2008	2009
Revenues:		
Government Solutions	\$ 54.9	\$ 74.4
Public Safety & Security	13.3	9.5
Total revenues	\$ 68.2	\$ 83.9
Operating income (loss):		
Government Solutions	\$ 0.8	\$(37.1)
Public Safety & Security	0.1	(1.3)
Unallocated Corporate income (expense), net	(0.2)	(1.2)
Total operating income (loss)	\$ 0.7	\$(39.6)

For the three months ended March 29, 2009, the KGS segment includes a non-cash charge of \$41.3 million related to goodwill impairment.

	As of December 28, 2008	As of March 29, 2009
Assets:		
Government Solutions	\$ 275.9	\$ 227.4
Public Safety & Security	17.2	14.6
Discontinued Operations	1.2	0.5
Corporate activities	18.1	14.1
Total assets	\$ 312.4	\$ 256.6

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KRATOS DEFENSE & SECURITY SOLUTIONS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Note 13. Legal Matters

Contingencies

IPO Securities Litigation

Beginning in June 2001, the Company and certain of its officers and directors were named as defendants in several parallel class action shareholder complaints filed in the United States District Court for the Southern District of New York, now consolidated under the caption, *In re Wireless Facilities, Inc. Initial Public Offering Securities Litigation*, Case 01-CV-4779. In the amended complaint, the plaintiffs allege that the Company, certain of its officers and directors, and the underwriters of the Company's initial public offering ("IPO") violated section 11 of the Securities Act of 1933 and section 10(b) of the Securities Exchange Act of 1934 based on allegations that the Company's registration statement and prospectus failed to disclose material facts regarding the compensation to be received by, and the stock allocation practices of, the IPO underwriters. The plaintiffs seek unspecified monetary damages and other relief. Similar complaints were filed in the same court against hundreds of other public companies ("Issuers") that conducted IPOs of their common stock in the late 1990s and 2000. These complaints have been consolidated into an action captioned *In re Initial Public Offering Securities Litigation*, 21 MC 92 (the "IPO Cases").

In June 2004, the Issuers (including the Company) executed a partial settlement agreement with the plaintiffs that would have, among other things, resulted in the dismissal with prejudice of all claims against the Issuers and their officers and directors and the assignment of certain potential Issuer claims to the plaintiffs. On February 15, 2005, the district court issued a decision certifying a class action for settlement purposes and granting preliminary approval of the settlement subject to modification of certain bar orders contemplated by the settlement. On August 31, 2005, the court reaffirmed class certification of the settlement class and preliminary approval of the modified settlement in a comprehensive Order. On February 24, 2006, the court dismissed litigation filed against certain underwriters in connection with certain claims to be assigned under the settlement. On April 24, 2006, the district court held a Final Fairness Hearing to determine whether to grant final approval of the settlement, and the court reserved decision at that time. While the partial settlement was pending approval, the plaintiffs continued to litigate against the underwriter defendants. The district court directed that the litigation proceed within a number of "focus cases" rather than all of the 310 cases that had been consolidated. The Company's case is not one of these focus cases. On October 13, 2004, the district court certified the focus cases as class actions. The underwriter defendants appealed that ruling and on December 5, 2006, the Second Circuit Court of Appeals reversed the district court's class certification decision. On April 6, 2007, the Second Circuit denied plaintiffs' rehearing petition, but clarified that the plaintiffs could seek to certify a more limited class in the district court. In light of the Second Circuit opinion, liaison counsel for all issuer defendants, including the Company, informed the district court that the settlement could not be approved because the defined settlement class, like the litigation class, could not be certified. On June 24, 2007, the district court entered an order terminating the proposed settlement.

Plaintiffs filed second consolidated amended complaints in the six focus cases on August 14, 2007, and, on September 27, 2007, again moved for class certification. On November 12, 2007, certain of the defendants in the focus cases moved to dismiss the second consolidated amended class action complaints. On March 26, 2008, the district court denied the motions to dismiss except as to section 11 claims raised by those plaintiffs who sold their securities for a price in excess of the initial offering

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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Note 13. Legal Matters (Continued)

price and those who purchased outside the previously certified class period. Briefing on the class certification motion was completed in May 2008. That motion was withdrawn without prejudice on October 10, 2008. On February 25, 2009, liaison counsel for the plaintiffs informed the district court that a settlement had been agreed to in principle, subject to formal approval by the parties and preliminary and final approval by the court. On April 2, 2009, a stipulation and agreement of settlement among the plaintiffs, issuer defendants and underwriter defendants was submitted to the Court for preliminary approval. If the Court grants the motion for preliminary approval, notice will be given to all class members of the settlement, a "fairness" hearing will be held and if the Court determines that the settlement is fair to the class members, the settlement will be approved. There can be no assurance that this proposed settlement will be approved and implemented in its current form, or at all. Due to the inherent uncertainties of litigation and because the settlement approval process is at a preliminary stage, the ultimate outcome of the matter is uncertain.

2004 Securities Litigation

In August 2004, following the Company's announcement on August 4, 2004 that it intended to restate its financial statements for the fiscal years ended December 31, 2000, 2001, 2002 and 2003, the Company and certain of its current and former officers and directors were named as defendants ("Defendants") in several securities class action lawsuits filed in the United States District Court for the Southern District of California. These actions were filed on behalf of those who purchased, or otherwise acquired, the Company's common stock between April 26, 2000 and August 4, 2004. The lawsuits generally alleged that, during that time period, Defendants made false and misleading statements to the investing public about the Company's business and financial results, causing its stock to trade at artificially inflated levels. Based on these allegations, the lawsuits alleged that Defendants violated the Securities Exchange Act of 1934, and the plaintiffs sought unspecified damages. These actions were consolidated into a single action *In re Wireless Facilities, Inc. Securities Litigation*, Master File 04CV1589-JAH. Plaintiffs filed a First Amended Consolidated Class Action Complaint on April 1, 2005. Defendants filed their motion to dismiss this first amended complaint on April 14, 2005. The plaintiffs then requested leave to amend their first amended complaint. The plaintiffs filed their Second Amended Complaint on June 9, 2005, this time on behalf of those who purchased, or otherwise acquired, the Company's common stock between May 5, 2003 and August 4, 2004. Defendants filed their motion to dismiss this Second Amended Complaint on July 14, 2005. The motion to dismiss was taken under submission on October 20, 2005 and on March 8, 2006, the Court granted the Defendants' motion. However, plaintiffs were granted the right to amend their complaint within 45 days and subsequently filed their Third Amended Consolidated Class Action Complaint on April 24, 2006. Defendants filed a motion to dismiss this complaint on June 8, 2006. On May 7, 2007, the Court denied the Defendants' motion to dismiss. Defendants' filed their answer to the plaintiffs' complaint on July 13, 2007. In February 2008, following a voluntary mediation of the matter, the parties reached a tentative agreement to settle the class action. In June 2008, the parties executed a Memorandum of Understanding documenting the essential terms of the proposed settlement and on August 8, 2008, the parties filed their joint motions for preliminary approval of the proposed settlement with the Court. The Court granted preliminary approval of the proposed settlement on September 3, 2008. On January 13, 2009, following a motion by the parties, the Court granted final approval of the proposed

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settlement terms, issued its final judgment on the matter, and entered an order dismissing the case with prejudice.

Pursuant to the settlement agreement and final order of the Court, plaintiffs and the class dismissed all claims, with prejudice, in exchange for a cash payment in the total amount of \$12 million. The Company's directors' and officers' liability insurers paid the settlement amount in accordance with the Company's insurance policies, less the applicable retention or co-insurance obligations that were paid directly by the Company. The Company's amount of payment toward the settlement was approximately \$2.4 million. In the fourth quarter of 2008, the Company paid \$3.0 million related to this matter, of which \$1.0 million was from its restricted cash account. The Company received \$0.6 million from the insurance carriers for this payment in the first quarter of 2009. Despite the settlement reached in this action, the Company believes that the allegations lacked merit.

In 2004, two derivative lawsuits were filed in the United States District Court for the Southern District of California against certain of the Company's current and former officers and directors: *Pedicini v. Wireless Facilities, Inc.*, Case 04CV1663; and *Roth v. Wireless Facilities, Inc.*, Case 04CV1810. These actions were consolidated into a single action in *In re Wireless Facilities, Inc. Derivative Litigation*, Lead Case No 04CV1663-JAH. These lawsuits contain factual allegations that are substantially similar to those made in the class action lawsuits, but the plaintiffs in these lawsuits assert claims for breach of fiduciary duty, gross mismanagement, abuse of control, waste of corporate assets, violation of Sarbanes Oxley Act section 304, unjust enrichment and insider trading. The plaintiffs in these lawsuits seek unspecified damages and equitable and/or injunctive relief. The lead plaintiff filed a consolidated complaint on March 21, 2005. On May 3, 2005, the defendants filed motions to dismiss this action, to stay this action pending the resolution of the consolidated non-derivative securities case pending in the Southern District of California, and to dismiss the complaint against certain non-California resident defendants. Pursuant to a request by the Court, Defendants' motions were withdrawn without prejudice pending a decision on defendants' motion to dismiss the complaint against the non-California resident defendants. On March 20, 2007, the Court ruled that it lacked personal jurisdiction over five of the six non-California defendants and dismissed them from the federal derivative complaint. On March 27, 2007, plaintiffs filed an amended derivative complaint setting forth all of the same allegations from the original complaint and adding allegations regarding the Company's stock option granting practices. Basically, plaintiffs allege that the Company "backdated" or "springloaded" employee stock option grants so that the options were granted at less than fair market value. The amended complaint names all of the original defendants (including those dismissed for lack of jurisdiction) as well as nine new defendants. On July 2, 2007, the non-California resident defendants moved to dismiss the complaint for lack of personal jurisdiction. On October 17, 2007, the Court took the motion under submission without oral argument. On February 26, 2008, the Court again ruled that it lacked personal jurisdiction over five of the six non-California defendants and dismissed them from the amended federal derivative complaint. Plaintiffs subsequently moved the Court for certification and entry of final judgment of the Court's order dismissing the non-residents for lack of personal jurisdiction so that the plaintiffs may seek immediate appellate review of the matter. On July 10, 2008, the court granted plaintiffs' motion for certification, which was not opposed by defendants. On August 12, 2008, Plaintiffs filed a notice of appeal of the personal jurisdictional order. Plaintiffs' opening appellate brief is due on June 10, 2009. The parties have conferred and discussed the Court's personal jurisdictional order, notice of appeal, and appellate briefing schedule and have stipulated to a

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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briefing schedule for any remaining motions to dismiss that the Company, along with the individual defendants subject to the court's jurisdiction, may bring in an effort to dismiss the complaint as to them. Pursuant to the parties' stipulation, such motions must be brought on or before May 26, 2009. The Company believes that the allegations lack merit and intends to vigorously defend all claims asserted. It is impossible at this time to assess whether or not the outcome of these proceedings will have a material adverse effect on the Company.

In April 2007, another derivative complaint was filed in the United States District Court for the Southern District of California, Hameed v. Tayebi, Case 07-CV-0680 BTM(RBB) (the "Hameed Action"), against several of the Company's current and former officers and directors. The allegations in this derivative complaint mirrored the amended allegations in the 2004 federal derivative action. Pursuant to a Court order and agreement of the parties, the defendants' responses to the complaint in the Hameed Action were stayed until the Court ruled on the motion to dismiss for lack of personal jurisdiction in the 2004 derivative litigation. As noted above, on February 26, 2008, the Court ruled that it lacked personal jurisdiction over five of the non-California defendants named in the 2004 derivative action, including three that were also named in the Hameed Action. In August 2008, and before defendants had responded to the complaint, Plaintiff voluntarily dismissed the Hameed Action pursuant to Federal Rule of Civil Procedure 41(a). The Company believes that the allegations lacked merit and intended to vigorously defend all claims asserted.

In August and September 2004, two virtually identical derivative lawsuits were filed in California Superior Court for San Diego County against certain of the Company's current and former officers and directors. These actions contain factual allegations similar to those of the federal lawsuits, but the plaintiffs in these cases assert claims for violations of California's insider trading laws, breaches of fiduciary duty, abuse of control, gross mismanagement, waste of corporate assets and unjust enrichment. The plaintiffs in these actions seek unspecified damages, equitable and/or injunctive relief and disgorgement of all profits, benefits and other compensation obtained by defendants. These lawsuits have been consolidated into one action. In re Wireless Facilities, Inc. Derivative Litigation, California Superior Court, San Diego County, Lead Case GIC 834253. The plaintiffs filed a Consolidated Shareholder Derivative Complaint on October 14, 2004. This action has been stayed pending a decision in federal court on a motion to dismiss the federal derivative lawsuit. In April 2009, the parties notified the Court of the status of the federal action and the court continued the stay for an additional six months. The Court also ordered the parties to file an updated status report in October 2009. The Company believes that the allegations lack merit and intends to vigorously defend all claims asserted. It is impossible at this time to assess whether or not the outcome of these proceedings will have a material adverse effect on the Company.

The Company has recorded an accrual for a contingent liability associated with the legal proceedings related to the derivative actions of \$0.7 million based on the Company's estimate of the potential amount it would have to pay in relation to these lawsuits.

2007 Securities Litigation

In March and April 2007, there were three federal class actions filed in the United States District Court for the Southern District of California against the Company and several of its current and former officers and directors. These class action lawsuits followed the Company's March 12, 2007

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Note 13. Legal Matters (Continued)

public announcement that it was conducting a voluntary internal review of its stock option granting processes. These actions were consolidated into a single action, *In re Wireless Facilities, Inc. Securities Litigation II*, Master File 07-CV-0482-BTM-NLS. The consolidated class action complaint was filed on November 19, 2007. In March 2008, following a voluntary mediation of the matter, the parties reached a tentative agreement to settle the class action. In May 2008, the parties executed a Memorandum of Understanding documenting the essential terms of the proposed settlement and on August 8, 2008, the parties filed their joint motions for preliminary approval of the proposed settlement with the Court. The Court granted preliminary approval of the proposed settlement on September 3, 2008. On December 19, 2008, following a motion by the parties, the Court granted final approval of the proposed settlement terms, issued its final judgment on the matter, and entered an order dismissing the case with prejudice.

Pursuant to the settlement agreement and final order of the Court, plaintiffs and the class dismissed all claims, with prejudice, in exchange for a cash payment in the amount of \$4.5 million. The Company's directors' and officers' liability insurers paid the settlement amount, less the applicable retention or co-insurance obligations and contributions that were paid directly by the Company. In July 2008, the Company paid \$1.8 million related to the settlement of this litigation. Despite the settlement reached in this action, the Company believes that the allegations lacked merit.

Other Litigation and Government Investigations

In January 2005, a former independent contractor of the Company filed a lawsuit in Brazil against the Company's subsidiary, WFI de Brazil, to which he had been assigned for a period of time. He sought to be designated an employee of WFI de Brazil and entitled to severance and related compensation pursuant to Brazilian labor law. The individual sought back wages, vacation pay, stock option compensation and related benefits in excess of \$0.5 million. This matter was argued before the appropriate labor court in July 2005 and in July 2006, the labor court awarded the individual the Brazilian currency equivalent of approximately \$0.4 million for his back wages, vacation pay and certain other benefits. The Company filed an appeal on the matter on July 20, 2006 and is challenging the basis for the award on several theories. The Company has accrued approximately \$0.4 million as of December 28, 2008, and March 29, 2009, respectively, related to this matter. On August 22, 2007, the appeals court partially upheld the Company's appeal, although it upheld the individual's designation as an employee. The court is reviewing possible damage calculations before publishing a final decision. The Company's counsel is preparing a motion for clarification of the judgment due to omissions in the decision.

On March 28, 2007, three plaintiffs, on behalf of a purported class of similarly situated employees and contractors, filed a lawsuit against the Company in the Superior Court of the State of California, Alameda County. The suit alleges various violations of the California Labor Code and seeks payments for allegedly unpaid straight time and overtime, meal period pay and associated penalties. The Company and the plaintiffs agreed to venue for the suit in San Diego County. Although the Company believes that the allegations lack merit, it has agreed with the plaintiffs to settle their claims for an aggregate amount in the range of \$0.3 million to \$0.5 million, to include individual and incentive awards, attorneys' fees and administrative costs, subject to court approval. The court granted final

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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Note 13. Legal Matters (Continued)

approval of the settlement on April 17, 2009. The Company will pay a total of \$0.3 million, and has an accrual for a contingent liability at March 29, 2009 associated with this legal proceeding in that amount.

On May 3, 2007, Kratos announced that it had filed a lawsuit against a former employee who previously served as its stock option administrator and left Kratos in mid-2004, and his spouse. The lawsuit sought to recover damages resulting from the theft by a former employee of Kratos stock options and common stock valued in excess of \$6.3 million. The thefts, which appear to have taken place during 2002 and 2003, were discovered through the Kratos review of its past practices related to the granting and pricing of employee stock options with the assistance of its outside counsel and forensic computer consultants. The complaint also alleged that the former employee attempted to cover up the scheme by, among other things, deleting entries from the records of Kratos.

Kratos promptly reported to the SEC the discovery of the theft. The SEC initiated an inquiry and commenced an enforcement action against the former employee. The U.S. Attorney's Office also forwarded a grand jury subpoena to Kratos seeking records related to the former employee and Kratos' historical option granting practices. The SEC filed a federal lawsuit and obtained a temporary restraining order and asset freeze against the former employee and his spouse. The U.S. Attorney's Office indicted him for the theft and he pled guilty to federal criminal charges and has been sentenced to 46 months in prison and currently is incarcerated. On April 1, 2008, the SEC notified Kratos that it had completed its investigation and that it did not intend to recommend any enforcement action by the SEC against the Company. Kratos has cooperated with, and continues to cooperate with the U.S. Attorney's Office on this matter and otherwise. The former employee and his wife entered into a settlement agreement with Kratos on October 5, 2007, turning over substantially all of their assets to Kratos in settlement of the damages incurred in the theft. On February 15, 2008, the SEC approved the settlement. On February 19, 2008, the court entered a final judgment approving the settlement. Kratos has obtained the assets, which aggregate approximately \$3.4 million and recovered \$0.6 million from its insurance carrier related to the theft of options, and is in the process of liquidating the remaining assets which approximate \$0.1 million in value. Kratos' directors' and officers' liability insurers agreed to reimburse it for \$4.1 million in the third and fourth quarters of 2008 related to fees previously incurred on the ongoing investigation by the U.S. Attorney's Office as well as fees previously incurred on the SEC investigation.

In addition to the foregoing matters, from time to time, the Company may become involved in various claims, lawsuits and legal proceedings that arise in the ordinary course of business. However, litigation is subject to inherent uncertainties, and an adverse result in these or other matters may arise from time to time that may harm the Company's business. The Company is currently not aware of any such legal proceedings or claims that it believes will have, individually or in the aggregate, a material adverse affect on our business, financial condition, operating results or cash flows.

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

This report contains forward-looking statements. These statements relate to future events or our future financial performance. 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 statements are only predictions. Actual events or results may differ materially. Factors that may cause our results to differ include, but are not limited to: changes in the scope or timing of our projects; 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 or cancellations of key government contracts; 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 obtain court approval of the proposed litigation settlement or to ultimately settle the litigation; failure to successfully consummate acquisitions or integrate acquired operations; and competition in the marketplace which could reduce revenues and profit margins.

Although we believe that the expectations reflected in the forward-looking statements are reasonable, we cannot guarantee future results, levels of activity, performance or achievements. Moreover, neither we, nor any other person, assume responsibility for the accuracy and completeness of the forward-looking statements. We are under no obligation to update any of the forward-looking statements after the filing of this Quarterly Report on Form 10-Q to conform such statements to actual results or to changes in our expectations.

Certain of the information set forth herein, including costs and expenses that exclude the impact of stock-based compensation expense, amortization expense, certain legal fees and accrual for unused office space, may be considered non-GAAP financial measures. We believe this information is useful to investors because it provides a basis for measuring the operating performance of our business and our cash flow, excluding the effect of items that would normally be included in the most directly comparable measures calculated and presented in accordance with GAAP. Our management uses these non-GAAP financial measures along with the most directly comparable GAAP financial measures in evaluating our operating performance, capital resources and cash flow. Non-GAAP financial measures should not be considered in isolation from, or as a substitute for, financial information presented in compliance with GAAP, and non-financial measures as reported by Kratos may not be comparable to similarly titled amounts reported by other companies.

The following discussion should be read in conjunction with our unaudited condensed consolidated financial statements and the related notes and other financial information appearing elsewhere in this Form 10-Q. Readers are also urged to carefully review and consider the various disclosures made by us which attempt to advise interested parties of the factors which affect our business, including without limitation the disclosures made under the caption "Management's Discussion and Analysis of Financial Condition and Results of Operations," in Item 1A "Risk Factors" and the audited consolidated financial statements and related notes included in our Annual Report filed on Form 10-K for the year ended December 28, 2008 and other reports and filings made with the Securities and Exchange Commission.

Overview

We are an innovative provider of mission critical engineering, information technology (IT) services and warfighter solutions. We work primarily for the U.S. government and federal government agencies, but we also perform work for state and local agencies and commercial customers. Our principal services are related to, but are not limited to, Command, Control, Communications, Computing, Intelligence, Surveillance and Reconnaissance (C4ISR); weapons systems lifecycle support and sustainment; military weapon range operations and technical services; missile, rocket and weapons system test and evaluation; missile and rocket mission launch services; public safety, security and surveillance systems; modeling and simulation; unmanned aerial vehicle (UAV) products and technology; advanced network

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engineering and information technology services; and advanced information technology services. We offer our customers solutions and expertise to support their mission-critical needs by leveraging our skills across our core service areas.

We derive a substantial portion of our revenue from contracts performed for federal government agencies, including the U.S. Department of Defense (DOD), with the majority of our revenue currently generated from the delivery of mission-critical warfighter solutions, advanced engineering services, system integration and system sustainment services to defense and other non-DOD and civilian government agencies. We believe our diversified and stable client base, strong client relationships, broad array of contract vehicles, considerable employee base possessing government security clearances, extensive list of past performance qualifications, and significant management and operational capabilities position us for continued growth.

Prior to 2008, we were also an independent provider of outsourced engineering and network deployment services, security systems engineering and integration services and other technical services for the wireless communications industry, the U.S. government and enterprise customers. In 2006 and 2007, we undertook a transformation strategy whereby we divested our commercial wireless-related businesses and chose to pursue business with the federal government, primarily the DOD, through strategic acquisitions. On September 12, 2007, we changed our name from Wireless Facilities, Inc. (WFI) to Kratos Defense & Security Solutions, Inc. (Kratos). Our new name reflects our revised focus as a defense contractor and security systems integrator for the federal government and for state and local agencies. In connection with our name change, we changed our NASDAQ Global Market trading symbol to "KTOS".

Current Reporting Segments

We operate in two principal business segments: Kratos Government Solutions (KGS) and Public Safety and Security (PSS). We organize our business segments based on the nature of the 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 financial statements in this Quarterly Report are presented in a manner consistent with operating structure. For additional information regarding our operating segments, see Note 12 of Notes to Condensed Consolidated Financial Statements. From a customer and solutions perspective, we view our business as an integrated whole, leveraging skills and assets wherever possible.

Kratos Government Solutions (KGS) Segment

The Kratos Government Solutions segment provides engineering, information technology and weapons systems to federal, state, and local government agencies, but primarily the DOD. Our work includes weapon systems sustainment, lifecycle support and extension; command, control, communications, computing, intelligence, surveillance and reconnaissance (C4ISR) services; military range operations and technical services; missile, rocket, and weapons systems test and evaluation; mission launch services; modeling and simulation, unmanned aerial vehicle (UAV) products and technology, and advanced network engineering and information technology services; public safety, security and surveillance systems integration. Our KGS segment also provides public safety, security and surveillance systems products and services to the homeland security market with products and services aimed at supporting first responders.

Public Safety and Security (PSS) Segment

The Public Safety and Security segment provides system design, deployment, integration, monitoring and support services for public safety, security and surveillance networks for state and local

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governments and commercial customers. Public safety and security networks have been traditionally segregated into systems such as voice, data, access control, video surveillance, temperature control and fire and life safety. We provide services that combine such systems and offer integrated solutions on an Ethernet-based platform. We also offer solutions that combine voice, data, electronic security and building automation systems with fixed or wireless connectivity solutions. Our target markets are retail, healthcare, education, sports and entertainment, municipal government, correctional facilities and other public facilities. Our commitments to these markets and our ability to provide feature-rich, cost-effective solutions have allowed us to become one of the larger independent integrators for these types of systems. We maintain regional office locations comprised of Kratos Mid Atlantic, Kratos Southeast, and Kratos Southwest.

Recent Acquisitions

On June 28, 2008, we completed our acquisition of SYS, a San Diego-based company. The acquisition enhances our position as a premier mid-tier federal, state and local government contractor in the United States in the areas of C4ISR, IT services and public safety and homeland security solutions. The merger creates a broad, complementary set of business offerings, and positions the Company to deliver capabilities to a wider spectrum of customers.

We issued 25.3 million shares to SYS shareholders in the acquisition, for a total purchase price of \$55.9 million including direct transaction costs of \$2.4 million. Each share of SYS common stock was converted into the right to receive 1.2582 shares of Kratos common stock. The value of the Kratos common stock issued in the acquisition was derived from the number of shares of Kratos common stock issued, or 25.3 million, at a price of \$2.022 per share, the average closing price of Kratos shares of common stock for the two days prior to, including, and the two days subsequent to the public announcement of the acquisition on February 21, 2008. Following the closing of the acquisition, we implemented a plan to restructure and/or exit certain business activities of SYS. The plan included a comprehensive assessment of personnel, relocation of personnel, facility consolidation and exit strategies for certain lines of business. The plan provided for approximately \$2.0 million of restructuring costs associated with personnel, and additional costs of \$0.5 million for facilities consolidation. The restructuring costs are primarily associated with the businesses sold and are accounted for in discontinued operations in the accompanying condensed consolidated financial statements.

In addition, we identified three business units of SYS that were not core to our business strategy and/or have been dilutive to profitability. We expect the divestiture of these businesses to slightly reduce revenues going forward, and increase profitability and cash flow. We recently completed the sale of these businesses in the first quarter of 2009 for an aggregate cash consideration of approximately \$0.4 million. These businesses have been classified as discontinued operations in our condensed consolidated financial statements as of March 29, 2009.

On December 24, 2008 we acquired Huntsville, Alabama based Digital Fusion, Inc. (DFI). DFI provides C4ISR and technical engineering services, UAV products and technology and has significant engineering, exotic sensor and modeling and simulation capabilities. The acquisition of DFI provides us with new customers and an expanded contract vehicle portfolio, in addition to expanding the range of service offerings to our existing customers. Principal customers of DFI include the Army Aviation and Missile Research, Development and Engineering Center (AMRDEC), Army Space and Missile Defense Command/Army Forces Strategic Command ARSTRAT), NASA Marshall Space Flight Center, and certain classified customers.

The total stock for stock transaction was valued at approximately \$37.0 million, including Kratos transaction costs of \$0.9 million. We issued 22.9 million shares to DFI shareholders and assumed outstanding DFI options, which resulted in the assumption of options to acquire approximately

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10.0 million Kratos shares. The value of the purchase price related to the common stock issued was derived from the number of shares of Kratos common stock issued of 22.9 million, based on 12.8 million shares of DFI common stock outstanding and the exchange ratio of 1.7933 for each DFI share, at a price of \$1.27 per share, the average closing price of Kratos shares of common stock for the two days prior to, including, and the two days subsequent to the public announcement of the merger on November 24, 2008. The fair value of the options assumed that were allocated to goodwill based upon the Black-Scholes pricing model was \$7.0 million. The fair value of unvested options which are related to future service will be expensed as the service is performed.

For a complete description of our business and a discussion of our complete critical accounting matters, please refer to Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations," in our 2008 Annual Report on Form 10-K filed with the Securities and Exchange Commission on March 10, 2009.

As of March 29, 2009, we consider the following factors to be important in understanding our financial statements.

Kratos Government Solutions' business with the U.S. government and prime contractors is generally performed under cost reimbursable, fixed-price or time and materials contracts. Cost reimbursable contracts for the government provide for reimbursement of costs plus the payment of a fee. Some cost reimbursable contracts include incentive fees that are awarded based on performance on the contract. Under fixed-price contracts, we agree to perform certain work for a fixed price. Under time and materials contracts, we are reimbursed for labor hours at negotiated hourly billing rates and reimbursed for travel and other direct expenses at actual costs plus applied general and administrative expenses. Our Public Security and Safety contracts are primarily fixed-price contracts whereby revenue is recognized using the percentage-of-completion method of accounting under the provisions of Statement of Position (SOP) 81-1, *Accounting for Performance of Construction Type and Certain Production Type Contracts*. For contracts offered on a time and material basis, we recognize revenues as services are performed.

Cost of revenues includes direct compensation, living, travel and benefit expenses for project-related personnel, payments to third-party subcontractors, cost of materials, project-related incentive compensation based upon the successful achievement of certain project performance goals, allocation of overhead costs and other direct project-related expenses. Selling, general and administrative expenses include compensation and benefits for corporate service employees and similar costs for billable employees whose time and expenses cannot be assigned to a project (underutilization costs), expendable computer software and equipment, facilities expenses and other operating expenses not directly related and/or allocated to projects. General and administrative costs include all corporate and administrative functions that support existing operations and provide infrastructure to facilitate our future growth. Additionally, our sales personnel and senior corporate executives have, as part of their compensation packages, periodic and annual bonus/commission incentives based on the attainment of specified performance goals.

We consider the following factors when determining if collection of a receivable is reasonably assured: comprehensive collection history; results of our communications with customers; the current financial position of the customer; and the relevant economic conditions in the customer's country. If we have had no prior experience with the customer, we review reports from various credit organizations to ensure that the customer has a history of paying its creditors in a reliable and effective manner. If the financial condition of our customers were to deteriorate, and adversely affect their financial ability to make payments, additional allowances would be required. Additionally, on certain contracts whereby we perform services for a prime/general contractor, a specified percentage of the invoiced trade accounts receivable may be retained by the customer until we complete the project. We periodically

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review all retainages for collectibility and record allowances for doubtful accounts when deemed appropriate, based on our assessment of the associated risks.

We believe that our Kratos Government Solutions segment will build and expand our customer relationships within the DOD, Department of Homeland Security and other non-DoD state and local agencies by taking advantage of the significant opportunities for companies with substantial expertise in advanced engineering and information technology. We believe we will experience continued growth in revenues and operating income from this operating segment. The acquisitions of Haverstick on December 31, 2007, SYS on June 28, 2008, and DFI on December 24, 2008 resulted in the addition of over 1,000 highly skilled technical professionals and engineers with expertise in the areas of military weapons and target range support as well as targets and missile operations and maintenance.

Comparison of Results for the Three Months Ended March 30, 2008 to the Three Months Ended March 29, 2009

Revenues. Revenues increased \$15.7 million from \$68.2 million for the three months ended March 30, 2008 to \$83.9 million for the three months ended March 29, 2009. This increase was primarily due to \$29.8 million in revenues from SYS and DFI, which were acquired on June 28, 2008 and December 24, 2008, respectively, partially offset by reductions in our commercial and public safety & security system integration business, which were negatively impacted by the current adverse economic environment, the completion of a sizable contract in our Southeast Division of PSS, and the planned reductions of acquired small business set aside contract work, pass through work and other contract work in our KGS business. Revenues by operating segment for the three months ended March 28, 2008 and March 29, 2009 are as follows (in millions):

	2008	2009	\$ change	% change
Government Solutions	\$54.9	\$74.4	\$ 19.5	35.5%
Public Safety & Security	13.3			