

KRATOS DEFENSE & SECURITY SOLUTIONS, INC.  
Form 10-Q  
May 07, 2015  
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UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

FORM 10-Q

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

For the Quarterly Period Ended March 29, 2015

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

Commission file number 001-34460

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

Delaware

13-3818604

(State or other jurisdiction of  
incorporation or organization)

(I.R.S. Employer Identification No.)

4820 Eastgate Mall, Suite 200

San Diego, CA 92121

(858) 812-7300

(Address, including zip code, and telephone number, including  
area code, of Registrant's principal executive offices)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (Section 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  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:

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 May 1, 2015, 53,281,685 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, 2015

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## PART I. FINANCIAL INFORMATION

## Item 1. Financial Statements.

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

	December 28, 2014	March 29, 2015
Assets		
Current assets:		
Cash and cash equivalents	\$34.7	\$34.4
Restricted cash	5.4	1.6
Accounts receivable, net	248.2	238.6
Inventoried costs	68.0	72.1
Prepaid expenses	8.5	8.4
Other current assets	10.1	11.1
Total current assets	374.9	366.2
Property, plant and equipment, net	82.6	81.5
Goodwill	596.4	596.4
Intangible assets, net	52.3	47.7
Other assets	32.6	30.8
Total assets	\$1,138.8	\$1,122.6
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	\$48.4	\$42.5
Accrued expenses	34.2	31.5
Accrued compensation	46.4	39.2
Accrued interest	5.6	16.5
Billings in excess of costs and earnings on uncompleted contracts	52.1	56.5
Deferred income tax liability	30.3	30.2
Other current liabilities	9.1	6.6
Total current liabilities	226.1	223.0
Long-term debt principal, net of current portion	622.0	622.0
Line of credit	41.0	41.0
Other long-term liabilities	25.4	25.1
Total liabilities	914.5	911.1
Commitments and contingencies		
Stockholders' equity:		
Preferred stock, \$0.001 par value, 5,000,000 shares authorized, 0 shares outstanding at December 28, 2014 and March 29, 2015	—	—
Common stock, \$0.001 par value, 195,000,000 shares authorized; 57,801,978 and 58,273,919 shares issued and outstanding at December 28, 2014 and March 29, 2015, respectively	—	—
Additional paid-in capital	863.4	867.1
Accumulated other comprehensive loss	(1.7	) (1.9
Accumulated deficit	(637.4	) (653.7
Total stockholders' equity	224.3	211.5
Total liabilities and stockholders' equity	\$1,138.8	\$1,122.6

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

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## KRATOS DEFENSE &amp; SECURITY SOLUTIONS, INC.

## CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME (LOSS)

(in millions, except per share amounts)

(Unaudited)

	Three Months Ended	
	March 30, 2014	March 29, 2015
Service revenues	\$100.6	\$87.4
Product sales	99.5	95.1
Total revenues	200.1	182.5
Cost of service revenues	74.1	66.0
Cost of product sales	73.4	69.6
Total costs	147.5	135.6
Gross profit	52.6	46.9
Selling, general and administrative expenses	43.4	42.6
Research and development expenses	5.2	4.8
Unused office space and other restructuring	0.7	1.0
Operating income (loss) from continuing operations	3.3	(1.5)
Other income (expense):		
Interest expense, net	(16.1)	(12.2)
Other income (expense), net	0.2	(0.4)
Total other expense, net	(15.9)	(12.6)
Loss from continuing operations before income taxes	(12.6)	(14.1)
Provision for income taxes from continuing operations	2.3	2.4
Loss from continuing operations	(14.9)	(16.5)
Income (loss) from discontinued operations	(0.1)	0.2
Net loss	\$(15.0)	\$(16.3)
Basic and diluted loss per common share:		
Net loss from continuing operations	\$(0.26)	\$(0.28)
Net loss from discontinued operations	0.00	0.00
Net loss per common share	\$(0.26)	\$(0.28)
Basic and diluted weighted average shares outstanding	57.4	58.3
Comprehensive Loss		
Net loss (from above)	\$(15.0)	\$(16.3)
Change in cumulative translation adjustment	(0.1)	(0.2)
Comprehensive loss	\$(15.1)	\$(16.5)

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

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

	Three Months Ended	
	March 30, 2014	March 29, 2015
Operating activities:		
Net loss	\$(15.0	) \$(16.3
Less: Income (loss) from discontinued operations	(0.1	) 0.2
Loss from continuing operations	(14.9	) (16.5
Adjustments to reconcile loss from continuing operations to net cash provided by (used in) operating activities from continuing operations:		
Depreciation and amortization	9.6	8.5
Stock-based compensation	1.8	2.0
Deferred income taxes	—	1.8
Amortization of deferred financing costs	1.3	0.5
Amortization of premium and discount on Senior Secured Notes	(1.0	) 0.3
Provision for doubtful accounts	0.1	0.1
Changes in unused office space accrual	0.2	—
Changes in assets and liabilities, net of acquisitions:		
Accounts receivable	17.8	9.6
Inventoried costs	(6.7	) (6.0
Prepaid expenses and other assets	2.2	(1.4
Accounts payable	(13.7	) (6.4
Accrued compensation	(6.3	) (7.2
Accrued expenses	(5.2	) (2.8
Advance payments received on contracts	—	1.7
Accrued interest payable	15.6	10.9
Billings in excess of costs and earnings on uncompleted contracts	(0.1	) 4.4
Income tax receivable and payable	1.8	(0.1
Other liabilities	(0.8	) (2.3
Net cash provided by (used in) operating activities from continuing operations	1.7	(2.9
Investing activities:		
Cash paid for acquisitions, net of cash acquired	(1.6	) —
Decrease in restricted cash	—	3.8
Capital expenditures	(3.1	) (2.2
Net cash provided by (used in) investing activities from continuing operations	(4.7	) 1.6
Financing activities:		
Repayment of debt	(0.2	) (0.2
Other	1.6	1.7
Net cash provided by financing activities from continuing operations	1.4	1.5
Net cash flows of continuing operations	(1.6	) 0.2
Net operating cash flows of discontinued operations	(0.5	) (0.2
Effect of exchange rate changes on cash and cash equivalents	—	(0.3
Net decrease in cash and cash equivalents	(2.1	) (0.3
Cash and cash equivalents at beginning of period	55.7	34.7
Cash and cash equivalents at end of period	\$53.6	\$34.4

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

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KRATOS DEFENSE & SECURITY SOLUTIONS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

Note 1. Summary of Significant Accounting Policies

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

(a)Basis of Presentation

The information as of March 29, 2015 and for the three months ended March 30, 2014 and March 29, 2015 is unaudited. The condensed consolidated balance sheet as of December 28, 2014 was derived from the Company’s audited consolidated financial statements at that date. In the opinion of management, these unaudited condensed consolidated financial statements include all adjustments, consisting of normal recurring adjustments necessary for a fair presentation of the Company’s financial position, results of operations and cash flows for the interim periods presented. The results have been prepared in accordance with the instructions to Form 10-Q and do not necessarily include all information and footnotes necessary for presentation in accordance with accounting principles generally accepted in the United States (“GAAP”). These unaudited condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and the related notes included in the Company’s audited annual consolidated financial statements for the fiscal year ended December 28, 2014, included in the Company’s Annual Report on Form 10-K filed with the U.S. Securities and Exchange Commission (“SEC”) on March 13, 2015 (the “Form 10-K”). Interim operating results are not necessarily indicative of operating results expected in subsequent periods or for the year as a whole.

(b)Principles of Consolidation

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

(c)Fiscal Year

The Company has a 52/53 week fiscal year ending on the last Sunday of the calendar year, with interim fiscal periods ending on the last Sunday of each calendar quarter. The three month periods ended March 30, 2014 and March 29, 2015 consisted of 13-week periods, respectively. There are 52 calendar weeks in the fiscal years ending on December 28, 2014 and December 27, 2015.

(d) Accounting Estimates

The preparation of condensed consolidated financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the condensed consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Such estimates include revenue recognition, allowance for doubtful accounts, warranties, inventory valuation, valuation of long-lived assets including identifiable intangibles and goodwill, accounting for income taxes including the related valuation allowance on the deferred tax asset and uncertain tax positions, contingencies and litigation, contingent acquisition consideration, stock-based compensation, losses on unused office space, and business

combination purchase price allocations. In the future, the Company may realize actual results that differ from the current reported estimates. If the estimates that the Company has used change in the future, such changes could have a material impact on the Company's consolidated financial position, results of operations and cash flows.

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

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Due to the size and nature of many of our contracts accounted for under the percentage-of-completion method of accounting, the estimation of total revenues and costs at completion is complicated and subject to many variables. For example, estimates are made regarding the length of time to complete a contract since costs also include expected increases in wages, prices for materials and allocated fixed costs. Similarly, assumptions are made regarding the future impact of our efficiency initiatives and cost reduction efforts. Incentives, awards or penalties related to performance on contracts are considered in estimating revenue and profit rates and are recorded when there is sufficient information to assess anticipated performance. Suppliers' assertions are also assessed and considered in estimating costs and profit rates.

The Company closely monitors the consistent application of its critical accounting policies and compliance with contract accounting. Business operations personnel conduct periodic contract status and performance reviews. Also, regular and recurring evaluations of contract cost, scheduling and technical matters are performed by management personnel who are independent from the business operations personnel performing work under the contract. When adjustments in estimated contract revenues or costs are required, any significant changes from prior estimates are included in earnings in the current period ("the cumulative catch-up method").

### (e) Accounting Standards Updates

In January 2015 the FASB issued Accounting Standards Update No. 2015-01 ("ASU 2015-1"), "Income Statement - Extraordinary and Unusual Items (Subtopic 225-20): Simplifying Income Statement Presentation by Eliminating the Concept of Extraordinary Items." ASU 2015-1 eliminates from GAAP the concept of extraordinary items. Subtopic 225-20, Income Statement - Extraordinary and Unusual Items, required that an entity separately classify, present, and disclose extraordinary events and transactions. Presently, an event or transaction is presumed to be an ordinary and usual activity of the reporting entity unless evidence clearly supports its classification as an extraordinary item. The amendments in this ASU are effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2015. The Company does not believe that the adoption of this guidance will have a material impact on its condensed consolidated financial statements.

In April 2014, the FASB issued Accounting Standards Update 2014-08 ("ASU 2014-08") "Presentation of Financial Statements (Topic 205) and Property, Plant, and Equipment (Topic 360): Reporting Discontinued Operations and Disclosures of Disposals of Components of an Entity." The amendments in the ASU 2014-08 change the criteria for reporting discontinued operations and requires enhanced disclosures in this area. Under the new guidance, only disposals representing a strategic shift in operations should be presented as discontinued operations. Those strategic shifts should have a major effect on the organization's operations and financial results. Examples include a disposal of a major geographic area, a major line of business, or a major equity method investment. In addition, the new guidance requires expanded disclosures about discontinued operations that will provide financial statement users with more information about the assets, liabilities, income, and expenses of discontinued operations. The new guidance also requires disclosure of the pre-tax income attributable to a disposal of a significant part of an organization that does not qualify for discontinued operations reporting. The amendments in ASU 2014-08 were effective in the first quarter of 2015 for public organizations with calendar year ends. The Company adopted this standard in the quarter ended March 29, 2015, which did not have a material impact on its condensed consolidated financial statements.

In May 2014, the FASB issued Accounting Standards Update 2014-09 ("ASU 2014-09") "Revenue from Contracts with Customers." ASU 2014-09 affects any entity using GAAP that either enters into contracts with customers to transfer goods or services or enters into contracts for the transfer of nonfinancial assets unless those contracts are within the scope of other standards (e.g., insurance contracts or lease contracts). ASU 2014-09 will supersede the revenue recognition requirements in Topic 605, Revenue Recognition, and most industry-specific guidance. The ASU also supersedes some cost guidance included in ASC Subtopic 605-35, Revenue Recognition—Construction-Type and Production-Type Contracts. For a public entity, the amendments in this ASU are effective for annual reporting periods beginning after December 15, 2016, including interim periods within that reporting period, however, a delay in the effective date is currently being considered by the FASB, which we expect will result in at least a one year deferral. Early application is not permitted. The guidance permits companies to either apply the requirements retrospectively to all prior periods presented or apply the requirements in the year of adoption, through a cumulative adjustment. The

Company has not yet selected a transition method nor has it determined the impact of adoption on its condensed consolidated financial statements.

In August 2014, the FASB issued Accounting Standards Update 2014-15 ("ASU 2014-15") "Presentation of Financial Statements—Going Concern (Subtopic 205-40): Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern." ASU 2014-15 is intended to define management's responsibility to evaluate whether there is substantial doubt about an organization's ability to continue as a going concern and to provide related footnote disclosures. Under GAAP, financial statements are prepared under the presumption that the reporting organization will continue to operate as a going concern, except in limited circumstances. Financial reporting under this presumption is commonly referred to as the going concern basis of accounting. The going concern basis of accounting is critical to financial reporting because it establishes the fundamental

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basis for measuring and classifying assets and liabilities. Currently, GAAP lacks guidance about management's responsibility to evaluate whether there is substantial doubt about the organization's ability to continue as a going concern or to provide related footnote disclosures. ASU 2014-15 provides guidance to an organization's management, with principles and definitions that are intended to reduce diversity in the timing and content of disclosures that are commonly provided by organizations today in the financial statement footnotes. The amendments are effective for annual periods ending after December 15, 2016, including interim periods within that reporting period. Early application is permitted for annual or interim reporting periods for which the financial statements have not previously been issued. The Company does not believe that the adoption of this guidance will have a material impact on its condensed consolidated financial statements.

There have been no changes in the Company's significant accounting policies, other than the adoption of ASU 2014-08, for the three months ended March 29, 2015 as compared to the significant accounting policies described in the Form 10-K.

## (f) Fair Value of Financial Instruments

The carrying amounts and the related estimated fair values of the Company's long-term debt financial instruments not measured at fair value on a recurring basis at December 28, 2014 and March 29, 2015 are presented in Note 7. The carrying value of all other financial instruments, including cash equivalents, accounts receivable, accounts payable, accrued expenses, billings in excess of cost and earnings on uncompleted contracts, income taxes payable and short-term debt, approximated their estimated fair values at December 28, 2014 and March 29, 2015 due to the short-term nature of these instruments.

## Note 2. Goodwill and Intangible Assets

## (a) Goodwill

The carrying amounts of goodwill as of December 28, 2014 and March 29, 2015 by reportable segment are as follows (in millions):

	Public Safety & Security	Kratos Government Solutions	Unmanned Systems	Total
Gross value	\$53.9	\$678.8	\$111.1	\$843.8
Less accumulated impairment	18.3	215.3	13.8	\$247.4
Net	\$35.6	\$463.5	\$97.3	\$596.4

## (b) Purchased Intangible Assets

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

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	As of December 28, 2014			As of March 29, 2015		
	Gross Value	Accumulated Amortization	Net Value	Gross Value	Accumulated Amortization	Net Value
Acquired finite-lived intangible assets:						
Customer relationships	\$99.0	\$(70.6)	) \$28.4	\$99.0	\$(74.2)	) \$24.8
Contracts and backlog	82.7	(80.0)	) 2.7	82.7	(80.2)	) 2.5
Developed technology and technical know-how	23.1	(10.9)	) 12.2	23.1	(11.5)	) 11.6
Trade names	6.0	(5.0)	) 1.0	6.0	(5.1)	) 0.9
Favorable operating lease	1.8	(0.7)	) 1.1	1.8	(0.8)	) 1.0
Total finite-lived intangible assets	212.6	(167.2)	) 45.4	212.6	(171.8)	) 40.8
Acquired indefinite-lived intangible assets:						
Trade names	6.9	—	) 6.9	6.9	—	) 6.9
Total intangible assets	\$219.5	\$(167.2)	) \$52.3	\$219.5	\$(171.8)	) \$47.7

Consolidated amortization expense related to intangible assets subject to amortization was \$5.6 million and \$4.6 million for the three months ended March 30, 2014 and March 29, 2015, respectively.

## Note 3. Inventoried Costs

Inventoried costs are stated at the lower of cost or market. Cost is determined using the average cost or first-in, first-out method and is applied consistently within an operating entity. Inventoried costs include work in process under fixed-price contracts using costs as the basis of the percentage-of-completion calculation under the units of delivery method of revenue recognition. These costs represent accumulated contract costs less the portion of such costs allocated to delivered items. Accumulated contract costs include direct production costs, factory overhead and production tooling costs. Pursuant to contract provisions of U.S. Government contracts, such customers may have title to, or a security interest in, inventories related to such contracts as a result of advances, performance-based payments or progress payments. The Company reflects those advances and payments as an offset against the related inventory balances.

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

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

	December 28, 2014	March 29, 2015
Raw materials	\$39.8	\$38.6
Work in process	22.3	29.2
Finished goods	4.7	4.9
Supplies and other	2.1	2.1
Subtotal inventoried costs	68.9	74.8
Less: Customer advances and progress payments	(0.9)	) (2.7)
Total inventoried costs	\$68.0	\$72.1

Note 4. Stockholders' Equity

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

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	For the Three Months Ended	
	March 30, 2014	March 29, 2015
Stockholders' equity at beginning of period	\$295.8	\$224.3
Comprehensive loss:		
Net loss	(15.0	) (16.3
Foreign currency translation	(0.1	) (0.2
Total comprehensive loss	(15.1	) (16.5
Exercise of stock options and warrants	(0.1	) —
Stock-based compensation	1.8	2.0
Employee stock purchase plan and restricted stock units settled in cash	1.8	1.8
Restricted stock units traded for taxes	(0.1	) (0.1
Stockholders' equity at end of period	\$284.1	\$211.5

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

	March 30, 2014	March 29, 2015
Cumulative translation adjustment	\$(0.4	) \$(0.9
Post retirement benefit reserve adjustment net of tax expense	(0.5	) (1.0
Total accumulated other comprehensive loss	\$(0.9	) \$(1.9

There were no reclassifications from other comprehensive income to net loss for the three months ended March 30, 2014 or March 29, 2015.

Common stock issued by the Company for the three months ended March 30, 2014 and March 29, 2015 was as follows (in millions):

	For the Three Months Ended	
	March 30, 2014	March 29, 2015
Shares outstanding at beginning of the period	57.1	57.8
Stock issued for employee stock purchase plan, stock options and restricted stock units exercised	0.3	0.5
Shares outstanding at end of the period	57.4	58.3

#### Note 5. Net Income (Loss) Per Common Share

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



Shares from stock options and awards, excluded from the calculation of diluted loss per share because their inclusion would have been anti-dilutive, were 1.2 million and 2.3 million for the three months ended March 30, 2014 and March 29, 2015, respectively.

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## Note 6. Income Taxes

A reconciliation of the income tax provision (benefit), computed by applying the statutory federal income tax rate of 35% to loss from continuing operations before income tax provision, to the income tax provision (benefit) for the three months ended March 30, 2014 and March 29, 2015 is as follows (in millions):

	For the Three Months Ended	
	March 30, 2014	March 29, 2015
Income tax benefit at federal statutory rate	\$(4.4	) \$(4.9
State and foreign taxes, net of federal tax benefit and valuation allowance	0.6	0.5
Nondeductible expenses and other	0.6	0.5
Impact of deferred tax liabilities for indefinite-lived assets	1.7	1.8
Increase in reserves for uncertain tax positions	—	0.1
Increase in federal valuation allowance	3.8	4.4
Total income tax provision	\$2.3	\$2.4

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

Federal and state income tax laws impose restrictions on the utilization of net operating loss ("NOL") and tax credit carryforwards in the event that an "ownership change" occurs for tax purposes, as defined by Section 382 of the Internal Revenue Code of 1986, as amended ("Section 382"). In general, an ownership change occurs when shareholders owning 5% or more of a "loss corporation" (a corporation entitled to use NOL or other loss carryovers) have increased their ownership of stock in such corporation by more than 50 percentage points during any three-year period. The annual base Section 382 limitation is calculated by multiplying the loss corporation's value at the time of the ownership change by the greater of the long-term tax-exempt rate determined by the Internal Revenue Service in the month of the ownership change or the two preceding months. This base limitation is subject to adjustments, including an increase for built-in gains recognized in the five-year period after the ownership change.

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

For the three months ended March 29, 2015, there was no impact of such limitations on the income tax provision, since the amount of taxable income did not exceed the annual limitation amount. In addition, future equity offerings or acquisitions that have equity as a component of the purchase price could also cause an "ownership change." If and when any other "ownership change" occurs, utilization of the NOL or other tax attributes may be further limited.

As discussed elsewhere, deferred tax assets relating to the NOL and credit carryforwards are offset by a full valuation allowance. In addition, utilization of state tax loss carryforwards is dependent upon sufficient taxable income apportioned to the states.

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

NOL carryforwards. Generally, the Company's tax years for 2002 and later are subject to examination by various foreign tax authorities.

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As of December 28, 2014, the Company had \$16.4 million of unrecognized tax benefits that, if recognized, would impact the effective income tax rate, subject to possible offset by an increase in the deferred tax asset valuation allowance. During the three months ended March 29, 2015, there was no change in the amount of unrecognized tax benefits relating to various current year and prior positions.

The Company recognizes interest and penalties related to unrecognized tax benefits in its provision for income taxes. For the three months ended March 30, 2014, there was no material expense recorded related to interest and penalties. For the three months ended March 29, 2015, the Company recorded an expense for interest and penalties of \$0.1 million. For the three months ended March 30, 2014 and March 29, 2015, there was no material benefit recorded related to interest and penalties. The Company believes that no significant amount of the liabilities for uncertain tax positions will expire within twelve months of March 29, 2015.

### Note 7. Debt

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

In May 2014, the Company refinanced its \$625.0 million 10% Senior Secured Notes due in 2017 (the "10% Notes") with \$625.0 million of newly issued 7.00% Senior Secured Notes due in 2019 (the "7% Notes"). The net proceeds of the 7% Notes was \$618.5 million after an original issue discount of \$6.5 million. The Company incurred debt issuance costs of \$8.8 million associated with the new 7% Notes. The Company utilized the net proceeds from the 7% Notes, a \$41.0 million draw on a new credit agreement discussed below, as well as cash from operations to extinguish the 10% Notes. The total reacquisition price of the 10% Notes was \$661.5 million including a \$31.2 million early termination fee, the write off of \$15.5 million of unamortized issue costs, \$12.9 million of unamortized premium, along with \$5.3 million of additional interest while in escrow, which resulted in a loss on extinguishment of \$39.1 million.

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

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

The Company pays interest on the Notes semi-annually, in arrears, on May 15 and November 15 of each year. The Notes include customary covenants and events of default as well as a consolidated fixed charge ratio of 2.0:1 for the incurrence of additional indebtedness. Negative covenants include, among other things, limitations on additional debt, liens, negative pledges, investments, dividends, stock repurchases, asset sales and affiliate transactions. Events of default include, among other events, non-performance of covenants, breach of representations, cross-default to other material debt, bankruptcy, insolvency, material judgments and changes in control. As of March 29, 2015, the Company was in compliance with the covenants contained in the Indenture governing the Notes.

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

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

(b) Other Indebtedness

\$110.0 Million Credit Agreement

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

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

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

equal to the sum of the applicable margin from time to time in effect plus the highest of (i) the Agent's prime lending rate, as in effect at such time, (ii) the federal funds rate, as in effect at such time, plus 0.50% per annum, and (iii) the adjusted LIBOR rate determined at such time for an interest period of one month, plus 1.00% per annum. Eurodollar revolving loans will bear interest at a rate per annum equal to the sum of the applicable margin from time to time in effect plus the adjusted LIBOR rate. The applicable margin varies between 1.50% - 2.00% for base rate revolving loans and swingline loans and 2.50% - 3.00% for Eurodollar loans, and is based on several factors including the Company's then-existing borrowing base and the Lender's total commitment amount and revolving credit exposure. The calculation of the Company's borrowing base takes into account several items relating to the Company and its subsidiaries, including amounts due and owing under billed and unbilled accounts receivables, then-held eligible raw materials inventory, work-in-process inventory, and applicable reserves. As of March 29, 2015, there was \$41.0 million outstanding on the Credit Agreement and \$13.1 million was outstanding on letters of credit, resulting in net borrowing base availability of \$38.4 million. The Company was in compliance with the financial covenants of the Credit Agreement as of March 29, 2015.

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## Debt Acquired in Acquisition

The Company has a 10-year term loan with a bank in Israel entered into on September 16, 2008 in connection with the acquisition of one of its wholly owned subsidiaries. The balance as of March 29, 2015 was \$3.5 million, and the loan is payable in quarterly installments of \$0.3 million plus interest at LIBOR plus a margin of 1.5%. The loan agreement contains various covenants, including a minimum net equity covenant as defined in the loan agreement. The Company was in compliance with all covenants, including the minimum net equity covenant, as of March 29, 2015.

## Fair Value of Long-term Debt

Carrying amounts and the related estimated fair values of the Company's long-term debt financial instruments not measured at fair value on a recurring basis at December 28, 2014 and March 29, 2015 are presented in the following table:

\$ in millions	As of December 28, 2014			As of March 29, 2015		
	Principal	Carrying Amount	Fair Value	Principal	Carrying Amount	Fair Value
Total Long-term debt including current portion	\$669.8	\$664.0	\$577.1	\$669.5	\$664.0	\$591.0

The fair value of the Company's long-term debt was based upon actual trading activity (Level 1, Observable inputs -quoted prices in active markets) and is the estimated amount the Company would have to pay to repurchase its debt, including any premium or discount attributable to the difference between the stated interest rate and market value of interest at the balance sheet date.

The net unamortized original issue discount of \$5.5 million as of March 29, 2015, which is the difference between the carrying amount of \$664.0 million and the principal amount of \$669.5 million presented in the previous table, is being accreted to interest expense over the term of the related debt.

## Note 8. Segment Information

The KGS reportable segment is comprised of an aggregation of Kratos' Government Solutions operating segments, including our electronic products, satellite communications, modular systems and defense and rocket support operating segments.

The new US reportable segment consists of our unmanned aerial, ground, seaborne and command, control and communications system business. The KGS and US segments provide products, solutions and services for mission critical national security priorities. KGS and US customers primarily include national security related agencies, the DoD, intelligence agencies and classified agencies, and to a lesser degree, international government agencies and domestic and international commercial customers. The PSS segment designs, engineers, deploys, operates and integrates into command and control infrastructure security and surveillance solutions for homeland security, public safety, critical infrastructure, government and commercial customers. PSS customers are in the critical infrastructure, power generation, power transport, nuclear energy, financial, IT, healthcare, education, transportation and petro-chemical industries, as well as certain government and military customers.

The Company organizes its reportable segments based on the nature of the products, solutions and services offered. Transactions between segments are generally negotiated and accounted for under terms and conditions similar to other government and commercial contracts. This presentation is consistent with the Company's operating structure. In the following table, prior year financial information has been recast to conform to the current reportable segments, and



total operating income of the reportable business segments is reconciled to the corresponding consolidated amount. The reconciling item “corporate activities” includes costs for certain stock-based compensation programs (including stock-based compensation costs for stock options, employee stock purchase plan and restricted stock units), the effects of items not considered part of management’s evaluation of segment operating performance, merger and acquisition expenses, corporate costs not allocated to the segments, and other miscellaneous corporate activities.

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Revenues, depreciation and amortization, and operating income (loss) generated by the Company's reportable segments for the three month periods ended March 30, 2014 and March 29, 2015 are as follows (in millions):

	Three Months Ended		
	March 30, 2014	March 29, 2015	
Revenues:			
Kratos Government Solutions			
Service revenues	\$51.7	\$49.8	
Product sales	79.8	82.7	
Total Kratos Government Solutions	131.5	132.5	
Public Safety & Security			
Service revenues	48.9	37.6	
Product sales	—	—	
Total Public Safety & Security	48.9	37.6	
Unmanned Systems			
Service revenues	—	—	
Product sales	19.7	12.4	
Total Unmanned Systems	19.7	12.4	
Total revenues	\$200.1	\$182.5	
Depreciation & amortization:			
Kratos Government Solutions	\$7.6	\$6.8	
Public Safety & Security	0.5	0.1	
Unmanned Systems	1.5	1.6	
Total depreciation and amortization	\$9.6	\$8.5	
Operating income (loss):			
Kratos Government Solutions	\$5.9	\$4.7	
Public Safety & Security	1.0	0.1	
Unmanned Systems	(1.8	) (4.1	)
Unallocated corporate expense, net	(1.8	) (2.2	)
Total operating income (loss)	\$3.3	\$(1.5	)

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Note 9. Significant Customers

Revenue from the U.S. Government, which includes foreign military sales, includes revenue from contracts for which the Company is the prime contractor as well as those for which the Company is a subcontractor and the ultimate customer is the U.S. Government. The KGS and US segments have substantial revenue from the U.S. Government. Sales to the U.S. Government amounted to approximately \$116.3 million and \$112.1 million, or 58% and 61% of total Kratos revenue, for the three months ended March 30, 2014 and March 29, 2015.

Note 10. Commitments and Contingencies

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

(a) Legal and Regulatory Matters

U.S. Government Cost Claims. The Company's contracts with the Department of Defense are subject to audit by the Defense Contract Audit Agency ("DCAA"). As a result of these audits, from time to time the Company is advised of claims concerning potential disallowed, overstated or disputed costs. For example, during the course of recent audits of the Company's contracts, the DCAA is closely examining and questioning certain of the established and disclosed practices that it had previously audited and accepted. Costs incurred and allocated to contracts with the U.S. Government are regularly scrutinized for compliance with regulatory standards by the Company's personnel.

Other Litigation Matters. The Company is subject to normal and routine litigation arising from the ordinary course and conduct of business and, at times, as a result of acquisitions and dispositions. Such disputes include, for example, commercial, employment, intellectual property, environmental and securities matters. The aggregate amounts accrued related to these matters are not material to the total liabilities of the Company. We intend to defend ourselves in any such matters and do not currently believe that the outcome of any such matters will have a material adverse impact on our financial condition, results of operations or cash flows.

(b) Warranty

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

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

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

	Three Months Ended	
	March 30, 2014	March 29, 2015
Balance at beginning of the period	\$5.4	\$5.3
Costs accrued and revenues deferred	0.4	0.1
Settlements made (in cash or kind) and revenues recognized and other	(0.1	) (0.1
Balance at end of period	5.7	5.3
Less: Current portion	(5.3	) (5.0
Non-current accrued product warranty and deferred warranty revenue	\$0.4	\$0.3

## Note 11. Condensed Consolidating Financial Statements

The Company has \$625.0 million in outstanding Senior Secured Notes (see Note 7). The Notes are guaranteed by all of the Company's 100% owned domestic subsidiaries (the "Subsidiary Guarantors") and are collateralized by the assets of all of the Company's 100% owned subsidiaries. The Notes are fully and unconditionally guaranteed on a joint and several basis by each Subsidiary Guarantor and the Company. There are no contractual restrictions limiting cash transfers from Subsidiary Guarantors by dividends, loans or advances to the Company. The Senior Secured Notes are not guaranteed by the Company's foreign subsidiaries (the "Non-Guarantor Subsidiaries").

The following tables present condensed consolidating financial statements for the parent company, the Subsidiary Guarantors and the Non-Guarantor Subsidiaries, respectively. The condensed consolidating financial information below follows the same accounting policies as described in the condensed consolidated financial statements, except for the use of the equity method of accounting to reflect ownership interests in 100% owned subsidiaries, which are eliminated upon consolidation.

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## Condensed Consolidating Balance Sheet

December 28, 2014

(Unaudited)

(in millions)

	Parent Company	Guarantors on a Combined Basis	Non-Guarantors on a Combined Basis	Eliminations	Consolidated
Assets					
Current Assets:					
Cash and cash equivalents	\$28.7	\$(6.0	) \$12.0	\$—	\$34.7
Accounts receivable, net	—	217.7	30.5	—	248.2
Amounts due from affiliated companies	341.9	—	—	(341.9	) —
Inventoried costs	—	49.9	18.1	—	68.0
Other current assets	4.4	16.3	3.3	—	24.0
Total current assets	375.0	277.9	63.9	(341.9	) 374.9
Property, plant and equipment, net	2.0	70.6	10.0	—	82.6
Goodwill	—	572.4	24.0	—	596.4
Intangible assets, net	—	52.2	0.1	—	52.3
Investment in subsidiaries	498.3	48.3	—	(546.6	) —
Amounts due from affiliated companies	—	3.2	—	(3.2	) —
Other assets	27.8	4.6	0.2	—	32.6
Total assets	\$903.1	\$1,029.2	\$98.2	\$(891.7	) \$1,138.8
Liabilities and Stockholders' Equity					
Current liabilities:					
Accounts payable	\$3.1	\$40.4	\$4.9	\$—	\$48.4
Accrued expenses	6.3	30.2	3.3	—	39.8
Accrued compensation	5.2	37.7	3.5	—	46.4
Billings in excess of costs and earnings on uncompleted contracts	—	47.0	5.1	—	52.1
Deferred income tax liability	—	30.3	—	—	30.3
Amounts due to affiliated companies	—	306.6	35.3	(341.9	) —
Other current liabilities	1.0	6.5	1.6	—	9.1
Total current liabilities	15.6	498.7	53.7	(341.9	) 226.1
Long-term debt, net of current portion	660.2	—	2.8	—	663.0
Amounts due to affiliated companies	—	—	3.2	(3.2	) —
Other long-term liabilities	3.0	20.2	2.2	—	25.4
Total liabilities	678.8	518.9	61.9	(345.1	) 914.5
Total stockholders' equity	224.3	510.3	36.3	(546.6	) 224.3
Total liabilities and stockholders' equity	\$903.1	\$1,029.2	\$98.2	\$(891.7	) \$1,138.8



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Condensed Consolidating Balance Sheet  
 March 29, 2015  
 (Unaudited)  
 (in millions)

	Parent Company	Guarantors on a Combined Basis	Non-Guarantors on a Combined Basis	Eliminations	Consolidated
Assets					
Current Assets:					
Cash and cash equivalents	\$21.6	\$0.4	\$12.4	\$—	\$34.4
Accounts receivable, net	—	209.7	28.9	—	238.6
Amounts due from affiliated companies	347.1	—	—	(347.1)	) —
Inventoried costs	—	51.9	20.2	—	72.1
Other current assets	2.9	14.7	3.5	—	21.1
Total current assets	371.6	276.7	65.0	(347.1)	) 366.2
Amounts due from affiliated companies, long-term	—	3.2	—	(3.2)	) —
Property, plant and equipment, net	1.9	69.7	9.9	—	81.5
Goodwill	—	572.4	24.0	—	596.4
Intangible assets, net	—	47.7	—	—	47.7
Investment in subsidiaries	499.4	52.7	—	(552.1)	) —
Other assets	27.4	3.3	0.1	—	30.8
Total assets	\$900.3	\$1,025.7	\$99.0	\$(902.4)	) \$1,122.6
Liabilities and Stockholders' Equity					
Current liabilities:					
Accounts payable	\$3.5	\$34.4	\$4.6	\$—	\$42.5
Accrued expenses	17.4	26.6	4.0	—	48.0
Accrued compensation	3.3	32.2	3.7	—	39.2
Billings in excess of costs and earnings on uncompleted contracts	—	52.0	4.5	—	56.5
Deferred income tax liability	—	30.3	(0.1)	) —	30.2
Amounts due to affiliated companies	—	314.8	32.3	(347.1)	) —
Other current liabilities	0.6	4.6	1.4	—	6.6
Total current liabilities	24.8	494.9	50.4	(347.1)	) 223.0
Long-term debt, net of current portion	660.5	—	2.5	—	663.0
Amounts due to affiliated companies	—	—	3.2	(3.2)	) —
Other long-term liabilities	3.5	19.4	2.2	—	25.1
Total liabilities	688.8	514.3	58.3	(350.3)	) 911.1
Total stockholders' equity	211.5	511.4	40.7	(552.1)	) 211.5
Total liabilities and stockholders' equity	\$900.3	\$1,025.7	\$99.0	\$(902.4)	) \$1,122.6



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## Condensed Consolidating Statement of Operations and Comprehensive Income (Loss)

Three Months Ended March 30, 2014

(Unaudited)

(in millions)

	Parent Company	Guarantors on a Combined Basis	Non-Guarantors on a Combined Basis	Eliminations	Consolidated
Service revenues	\$—	\$98.3	\$2.3	\$—	\$100.6
Product sales	—	86.3	16.6	(3.4)	99.5
Total revenues	—	184.6	18.9	(3.4)	200.1
Cost of service revenues	—	72.4	1.7	—	74.1
Cost of product sales	—	64.9	11.9	(3.4)	73.4
Total costs	—	137.3	13.6	(3.4)	147.5
Gross profit	—	47.3	5.3	—	52.6
Selling, general and administrative expenses	5.0	35.8	3.3	—	44.1
Research and development expenses	—	4.7	0.5	—	5.2
Operating income (loss) from continuing operations	(5.0)	6.8	1.5	—	3.3
Other income (expense):					
Interest expense, net	(16.0)	—	(0.1)	—	(16.1)
Other income (expense), net	(0.1)	0.1	0.2	—	0.2
Total other income and expense, net	(16.1)	0.1	0.1	—	(15.9)
Income (loss) from continuing operations before income taxes	(21.1)	6.9	1.6	—	(12.6)
Provision for income taxes from continuing operations	0.3	1.9	0.1	—	2.3
Income (loss) from continuing operations	(21.4)	5.0	1.5	—	(14.9)
Loss from discontinued operations	—	(0.1)	—	—	(0.1)
Equity in net income (loss) of subsidiaries	6.4	1.5	—	(7.9)	—
Net income (loss)	\$(15.0)	\$6.4	\$1.5	\$(7.9)	\$(15.0)
Comprehensive income (loss)	\$(15.1)	\$6.4	\$1.4	\$(7.8)	\$(15.1)

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Condensed Consolidating Statement of Operations and Comprehensive Income (Loss)  
 Three Months Ended March 29, 2015  
 (Unaudited)  
 (in millions)

	Parent Company	Guarantors on a Combined Basis	Non-Guarantors on a Combined Basis	Eliminations	Consolidated
Service revenues	\$—	\$85.4	\$2.0	\$—	\$87.4
Product sales	—	82.9	15.2	(3.0)	95.1
Total revenues	—	168.3	17.2	(3.0)	182.5
Cost of service revenues	—	64.5	1.5	—	66.0
Cost of product sales	—	62.0	10.6	(3.0)	69.6
Total costs	—	126.5	12.1	(3.0)	135.6
Gross profit	—	41.8	5.1	—	46.9
Selling, general and administrative expenses	5.1	35.4	3.1	—	43.6
Research and development expenses	—	4.6	0.2	—	4.8
Operating income (loss) from continuing operations	(5.1)	) 1.8	1.8	—	(1.5)
Other income (expense):					
Interest expense, net	(12.1)	) (0.1)	) —	—	(12.2)
Other income (expense), net	—	(3.1)	) 2.7	—	(0.4)
Total other income and expense, net	(12.1)	) (3.2)	) 2.7	—	(12.6)
Income (loss) from continuing operations before income taxes	(17.2)	) (1.4)	) 4.5	—	(14.1)
Provision for income taxes from continuing operations	0.3	2.0	0.1	—	2.4
Income (loss) from continuing operations	(17.5)	) (3.4)	) 4.4	—	(16.5)
Income from discontinued operations	0.1	0.1	—	—	0.2
Equity in net income (loss) of subsidiaries	1.1	4.4	—	(5.5)	) —
Net income (loss)	\$(16.3)	) \$1.1	\$4.4	\$(5.5)	) \$(16.3)
Comprehensive income (loss)	\$(16.5)	) \$1.1	\$4.2	\$(5.3)	) \$(16.5)

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Condensed Consolidating Statement of Cash Flows  
 Three Months Ended March 30, 2014  
 (Unaudited)  
 (in millions)

	Parent Company	Guarantors on a Combined Basis	Non-Guarantors on a Combined Basis	Eliminations	Consolidated
Net cash provided by (used in) operating activities	\$ (2.4	) \$ 5.1	\$ (1.0	) \$—	\$ 1.7
Investing activities:					
Cash paid for acquisitions, net of cash acquired	—	(1.6	) —	—	(1.6
Investment in affiliated companies	(0.5	) (0.6	) —	1.1	—
Capital expenditures	(0.3	) (2.2	) (0.6	) —	(3.1
Net cash provided by (used in) investing activities from continuing operations	(0.8	) (4.4	) (0.6	) 1.1	(4.7
Financing activities:					
Repayment of debt	—	—	(0.2	) —	(0.2
Financing from affiliated companies	—	—	1.1	(1.1	) —
Other, net	1.6	—	—	—	1.6
Net cash provided by (used in) financing activities from continuing operations	1.6	—	0.9	(1.1	) 1.4
Net cash flows of continuing operations	(1.6	) 0.7	(0.7	) —	(1.6
Net operating cash flows from discontinued operations	—	(0.5	) —	—	(0.5
Net increase (decrease) in cash and cash equivalents	\$ (1.6	) \$ 0.2	\$ (0.7	) \$—	\$ (2.1

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## Condensed Consolidating Statement of Cash Flows

Three Months Ended March 29, 2015

(Unaudited)

(in millions)

	Parent Company	Guarantors on a Combined Basis	Non-Guarantors on a Combined Basis	Eliminations	Consolidated
Net cash provided by (used in) operating activities	\$ (3.3 )	\$ (0.7 )	\$ 1.1	\$—	\$ (2.9 )
Investing activities:					
Cash paid for acquisitions, net of cash acquired	—	—	—	—	—
Investment in affiliated companies	(5.4 )	—	—	5.4	—
(Increase) decrease in restricted cash	—	3.8	—	—	3.8
Capital expenditures	(0.1 )	(1.9 )	(0.2 )	—	(2.2 )
Net cash provided by (used in) investing activities from continuing operations	(5.5 )	1.9	(0.2 )	5.4	1.6
Financing activities:					
Repayment of debt	—	—	(0.2 )	—	(0.2 )
Financings from affiliated companies	—	5.4	—	(5.4 )	—
Other, net	1.7	—	—	—	1.7
Net cash provided by (used in) financing activities from continuing operations	1.7	5.4	(0.2 )	(5.4 )	1.5
Net cash flows of continuing operations	(7.1 )	6.6	0.7	—	0.2
Net operating cash flows from discontinued operations	—	(0.2 )	—	—	(0.2 )
Effect of exchange rate changes on cash and cash equivalents	—	—	(0.3 )	—	(0.3 )
Net increase (decrease) in cash and cash equivalents	\$ (7.1 )	\$ 6.4	\$ 0.4	\$—	\$ (0.3 )

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

This Quarterly Report on Form 10-Q (this “Quarterly Report”) contains “forward-looking statements” relating to our future financial performance, the market for our services and our expansion plans and opportunities. In some cases, you can identify forward-looking statements by terminology such as “may,” “will,” “should,” “expect,” “plan,” “anticipate,” “believe,” “estimate,” “predict,” “potential,” or “continue,” the negative of such terms or other comparable terminology. These forward-looking statements reflect our current beliefs, expectations and projections, are based on assumptions, and are subject to known and unknown risks and uncertainties that could cause our actual results or achievements to differ materially from any future results or achievements expressed in or implied by our forward-looking statements. Many of these factors are beyond our ability to control or predict. As a result, you should not place undue reliance on forward-looking statements. The most important risks and uncertainties that could cause our actual results or achievements to differ materially from the results or achievements reflected in our forward-looking statements include, but are not limited to: changes or cutbacks in spending or the appropriation of funding by the federal government, including the U.S. Department of Defense, which could cause delays, cancellations or reductions of key government contracts; bid protests; changes in the scope or timing of our projects; the timing, rescheduling or cancellation of significant customer contracts and agreements, or consolidation by or the loss of key customers; risks of adverse regulatory action or litigation; risks associated with debt leverage; failure to successfully achieve our integration, cost reduction or divestiture strategies; risks related to security breaches, cybersecurity attacks or other significant disruptions of our information systems; and competition in the marketplace, which could reduce revenues and profit margins, as well as the additional risks and uncertainties described in this Quarterly Report on Form 10-Q and in “Item 1A-Risk Factors” of our Annual Report on Form 10-K for the fiscal year ended December 28, 2014 filed with the Securities and Exchange Commission on March 13, 2015. These forward-looking statements reflect our views and assumptions only as of the date such forward-looking statements are made. Except as required by law, we assume no responsibility for updating any forward-looking statements, whether as a result of new information, future events or otherwise.

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

Overview

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

We design, engineer and manufacture specialized electronic products, components, subsystems and systems for intelligence, surveillance, and reconnaissance (ISR), electronic attack, electronic warfare, radar, and missile system platforms; integrated products, software and technology solutions for satellite communications, signal monitoring and signal intelligence; products and solutions for unmanned aerial, ground and seaborne systems; products and services related to cybersecurity and cyberwarfare; products and solutions for ballistic missile defense; weapons systems trainers; advanced network engineering and information technology services; weapons systems lifecycle support and sustainment; military weapon range operations and technical services; and public safety, critical infrastructure security and surveillance systems. We believe our stable customer base, strong customer relationships, intellectual property,

broad array of contract vehicles, "designed in" positions on strategic national security platforms, large technically oriented employee base possessing specialized skills, specialized manufacturing facilities and equipment, extensive list of past performance qualifications, and significant management and operational capabilities position us for success.

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

#### Industry Update

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On December 13, 2014, the Senate passed a \$1.1 trillion omnibus appropriations bill, the “Consolidated and Further Continuing Appropriations Act, 2015. The legislation will fund most of the government through fiscal year 2015 (the period running from October 1st to September 30th, a “FY”). The Consolidated and Further Continuing Appropriations Act, 2015 includes the Department of Defense Appropriations Act of 2015, which provides \$554.2 billion in base and overseas contingency operation funding, compared to \$572 billion enacted in FY 2014 and \$554.3 billion in the President’s budget request. The base budget appropriation was \$496.1 billion, with \$64.2 billion for Overseas Contingency Operations (OCO) of the Department of Defense (DoD), compared to \$85.2 billion for DoD OCO enacted in FY 2014. On February 2, 2015, Congress was sent a proposed FY 2016 DoD budget request of \$585.3 billion in discretionary budget authority to fund both base budget programs and OCO. The FY 2016 base budget request of \$534.3 billion includes an increase of \$38.2 billion over the FY 2015 enacted budget of \$496.1 billion. DoD’s FY 2016 OCO budget request of \$50.9 billion is \$13.3 billion, or about 21% lower than the FY 2015 enacted level of \$64.2 billion, reflecting the end of the combat mission and the continued draw down of forces in Afghanistan. The combined request represents an increase of \$24.9 billion or about four percent, reflecting the need to modernize the force for the future and respond to emerging security challenges.

The FY 2016 budget request supports the 2014 Quadrennial Defense Review (QDR) strategy, beginning with its three pillars: protect the homeland, build security globally, and project power and win decisively. The budget also reaffirms the five key priorities identified in the QDR. These include the re-balance to the Asia-Pacific region, a strong commitment to security and stability in Europe and the Middle East, a global approach to countering violent extremists, key investments in technology, and strengthening alliances and partnerships around the world.

The FY 2016 budget request proposes investments in the modernization of key capability areas, including nuclear deterrence, space, missile defense, cyber security, and power protection. The budget also resubmits a number of critical reforms proposed in the FY 2015 budget, including improvements to DoD business operations, force structure modifications, streamlining our base infrastructure, strengthening sexual assault prevention and response programs, and providing for service members and their families. The budget maintains a prudent balance among Joint Force capacities, capabilities, and readiness, and continues to keep faith with service members and their families.

Unless a FY 2016 federal budget is agreed to by the President and Congress, sequestration will return with the beginning of FY 2016, on October 1, 2015, with an approximate base defense budget of \$500 billion.

## Reportable Segments

The KGS reportable segment is comprised of an aggregation of Kratos’ Government Solutions operating segments, including our electronic products, satellite communications, modular systems and rocket support operating segments. The Unmanned Systems reportable segment consists of our unmanned aerial system and unmanned ground system businesses operating segment. The PSS reportable segment remains unchanged. This change in segment reporting presentation does not change any consolidated totals. We made this segment reporting change because we believe that the new presentation will provide investors with greater insight into our consolidated results and operating performance. Throughout this Quarterly Report on Form 10-Q, all segment information for the period ended March 30, 2014 has been recast to conform to the new segment reporting presentation. We organize our business segments based primarily on the nature of the products, solutions and services offered. Transactions between segments are negotiated and accounted for under terms and conditions similar to other government and commercial contracts, and these intercompany transactions are eliminated in consolidation. The condensed consolidated financial statements in this Quarterly Report are presented in a manner consistent with our operating structure. For additional information regarding our reportable segments, see Note 8 of the 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.

Key Financial Statement Concepts

For a complete description of our business and a discussion of our critical accounting matters, please refer to Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations," in the Form 10-K.

As of March 29, 2015, we consider the following factors to be important in understanding our financial statements.

The KGS and US segments business with the U.S. Government and prime contractors is generally performed under fixed price, time and material and cost reimbursable contracts. In accounting for our long-term contracts for production of products and services provided to the U.S. Government and provided to our PSS segment customers under fixed price contracts, we utilize both cost-to-cost and units delivered measures under the percentage-of-completion method of accounting



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under the provisions of ASC Topic 605, Revenue Recognition. Under the units delivered measure of the percentage-of-completion method of accounting, sales are recognized as the units are accepted by the customer generally using sales values for units in accordance with the contract terms. We estimate profit as the difference between total estimated revenue and total estimated cost of a contract and recognize that profit over the life of the contract based on deliveries or as computed on the basis of the estimated final average unit costs plus profit. We classify contract revenues as product sales or service revenues depending upon the predominant attributes of the relevant underlying contracts. Cost reimbursable contracts for the U.S. 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 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.

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

We monitor our policies and procedures with respect to our contracts on a regular basis to ensure consistent application under similar terms and conditions as well as compliance with all applicable government regulations. In addition, costs incurred and allocated to contracts with the U.S. Government are routinely audited by the Defense Contract Audit Agency.

We manage and assess the performance of our businesses based on our performance on individual programs and contracts and programs obtained generally from government organizations with consideration given to the "Critical Accounting Principles and Estimates" as described in the Form 10-K. Due to the Federal Acquisition Regulation rules that govern our business, most types of costs are allowable, and we do not focus on individual cost groupings (such as cost of sales or general and administrative costs) as much as we do on total contract costs, which are a key factor in determining contract operating income. As a result, in evaluating our operating performance, we look primarily at changes in sales and service revenue and at operating income, including the effects of significant changes in operating income. Changes in contract estimates are reviewed on a contract-by-contract basis and are revised periodically throughout the life of the contract such that adjustments to profit resulting from revisions are made cumulative to the date of the revision in accordance with GAAP. Significant management judgments and estimates, including the estimated costs to complete the project, which determine the project's percent complete, must be made and used in connection with the revenue recognized in any accounting period. Material differences may result in the amount and timing of our revenue for any period if management makes different judgments or utilizes different estimates.

Comparison of Results for the Three Months Ended March 30, 2014 to the Three Months Ended March 29, 2015

Revenues. Revenues by operating segment for the three months ended March 30, 2014 and March 29, 2015 are as follows (dollars in millions):



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	March 30, 2014	March 29, 2015	\$ change	% change	
Kratos Government Solutions					
Service revenues	\$51.7	\$49.8	\$(1.9)	(3.7)	)%
Product sales	79.8	82.7	2.9	3.6	)%
Total Kratos Government Solutions	131.5	132.5	1.0	0.8	)%
Public Safety & Security					
Service revenues	48.9	37.6	(11.3)	(23.1)	)%
Product sales	—	—	—	N/A	
Total Public Safety & Security	48.9	37.6	(11.3)	(23.1)	)%
Unmanned Systems					
Service revenues	—	—	—	N/A	
Product sales	19.7	12.4	(7.3)	(37.1)	)%
Total Unmanned Systems	19.7	12.4	(7.3)	(37.1)	)%
Total revenues	\$200.1	\$182.5	\$(17.6)	(8.8)	)%

Revenues decreased \$17.6 million from \$200.1 million for the three months ended March 30, 2014 to \$182.5 million for the three months ended March 29, 2015. The decrease in revenues was primarily due to a decline in shipments of certain of our defense products, and delays in orders and awards as a result of the challenging federal government and DoD funding environment, all of which adversely impacted the timing of new contract awards, bookings and our revenues. For the three months ended March 29, 2015, KGS segment revenue increased by \$1.0 million. The increase in the KGS segment revenue was primarily driven by growth in our simulation and training business of \$2.6 million and in technical government services where we support directed energy weapons and electromagnetic railgun efforts of \$4.8 million, partially offset by a reduction in our legacy government services revenues of \$5.0 million. For the three months ended March 29, 2015, PSS segment revenue decreased by \$11.3 million, primarily due to the Company's change in strategic direction in the fourth quarter of 2014 to only selectively bid on larger security integration projects that traditionally generate lower margins. PSS segment revenues were also impacted by the completion or wind-down of certain security installation projects which occurred in the fourth quarter of 2014 and the first quarter of 2015. Revenues in our US segment were impacted by the reduction of shipments of certain of our aerial target products due primarily to delays in the timing of follow-on and new international contract awards.

Product sales decreased \$4.4 million from \$99.5 million for the three months ended March 30, 2014 to \$95.1 million for the three months ended March 29, 2015, primarily as a result of the decline in product shipments due to the factors discussed above in our US segment. As a percentage of total revenue, product sales were 49.7% for the three months ended March 30, 2014 as compared to 52.1% for the three months ended March 29, 2015. Service revenues decreased by \$13.2 million from \$100.6 million for the three months ended March 30, 2014 to \$87.4 million for the three months ended March 29, 2015. The decrease was primarily related to the change in strategic direction and the completion of larger security installation projects in our PSS segment as well as the continued reduction in our legacy government services business as discussed above.

Cost of Revenues. Cost of revenues decreased \$11.9 million from \$147.5 million for the three months ended March 30, 2014 to \$135.6 million for the three months ended March 29, 2015. The decrease in cost of revenues was primarily a result of the revenue changes discussed above.

Gross margin decreased from 26.3% for the three months ended March 30, 2014 to 25.7% for the three months ended March 29, 2015. Margins on services decreased from the three months ended March 30, 2014 to March 29, 2015, from 26.3% to 24.5%, respectively, due primarily to a less favorable mix of revenues. Margins on products increased from the three months ended March 30, 2014 to March 29, 2015 from 26.2% to 26.8%, respectively, primarily due to the mix of products shipped. Margins in the KGS segment decreased from 26.8% for the three months ended

March 30, 2014 to 26.5% for the three months ended March 29, 2015, primarily as a result of a less favorable mix of revenues. Margins in the US segment decreased from 25.4% for the three months ended March 30, 2014 to 15.3% for the three months ended March 29, 2015, primarily due to a less favorable mix of products produced and shipped. Margins in the PSS segment increased from 25.4% for the three months ended March 30, 2014 to 26.3% for the three months ended March 29, 2015 due primarily to a more favorable mix of revenues and the impact of cost reduction actions that were taken in the first quarter of 2015.

Selling, General and Administrative (SG&A) Expenses. SG&A expenses decreased \$0.8 million from \$43.4 million for the three months ended March 30, 2014 to \$42.6 million for the three months ended March 29, 2015, primarily as a result of a \$1.0 million reduction of amortization of intangibles as a result of certain intangible assets being fully amortized, as well as

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our cost reduction actions. As a percentage of revenues, SG&A increased slightly from 21.7% at March 30, 2014 to 23.3% at March 29, 2015. Excluding amortization of intangibles of \$5.6 million for the three months ended March 30, 2014 and amortization of intangibles of \$4.6 million for the three months ended March 29, 2015, SG&A increased as a percentage of revenues from 18.9% to 20.8%, or from \$37.8 million to \$38.0 million for the three months ended March 30, 2014 and March 29, 2015, respectively, due primarily as a result of the decline in revenues discussed previously.

Internal Research and Development ("IR&D") Expenses. IR&D expenses were \$5.2 million for the three months ended March 30, 2014 and \$4.8 million for the three months ended March 29, 2015. As a percentage of revenues, IR&D remained constant at 2.6% of revenues in the three months ended March 30, 2014 and the three months ended March 29, 2015. IR&D expenditures are primarily related to investments we are making in conjunction with our customers, with the objectives of the Company's products being "designed in" to these new long term program opportunities and the Company owning certain intellectual property rights for products that support these programs.

Unused office space and other restructuring. The expense of \$0.7 million for the three months ended March 30, 2014 was primarily due to an estimated excess facility accrual of office space at our Sacramento, California administrative facilities, and employee termination costs related to personnel reduction actions taken during the first quarter of 2014. The expense of \$1.0 million for the three months ended March 29, 2015 was primarily due to employee termination costs related to personnel reduction actions taken during the first quarter of 2015 of \$0.9 million.

Other Expense, Net. Other expense, net decreased from \$15.9 million to \$12.6 million for the three months ended March 30, 2014 and March 29, 2015, respectively. The decrease in expense of \$3.3 million is primarily related to a reduction in interest expense as a result of the refinancing of our 10% Senior Secured Notes with our 7% Senior Secured Notes which occurred in the second quarter of 2014.

Provision for Income Taxes. Income tax expense for the three months ended March 30, 2014 and March 29, 2015 was \$2.3 million and \$2.4 million, respectively. These amounts were primarily a function of the estimated effective tax rate for the respective years. The estimated effective tax rate for any given year is driven by estimated foreign taxes, estimated state taxes, permanent book/tax differences, tax amortization of intangible assets that have an indefinite life under GAAP and the projected income or loss for the year.

Income (loss) from Discontinued Operations. There was no revenue from discontinued operations for the three months ended March 30, 2014 and March 29, 2015, respectively. The loss from discontinued operations was \$0.1 million for the three months ended March 30, 2014 and income of \$0.2 million for the three months ended March 29, 2015, and was primarily related to operations of the non-core businesses from our acquisition of Integral Systems, Inc. that were classified as held for sale and subsequently sold.

## Backlog

At March 30, 2014 and March 29, 2015, our backlog was approximately \$1.1 billion and \$1.1 billion of which \$538.0 million was funded in 2014 and \$650.0 million was funded in 2015. Backlog is our estimate of the amount of revenue we expect to realize over the remaining life of awarded contracts and task orders that we have in hand as of the measurement date. Our total backlog consists of funded and unfunded backlog. We define funded backlog as estimated future revenue under government contracts and task orders for which funding has been appropriated by Congress and authorized for expenditure by the applicable agency, plus our estimate of the future revenue we expect to realize from our commercial contracts that are under firm orders. Our funded backlog does not include the full

potential value of our contracts because Congress often appropriates funds to be used by an agency for a particular program of a contract on a yearly or quarterly basis even though the contract may call for performance over a number of years. As a result, contracts typically are only partially funded at any point during their term, and all or some of the work to be performed under the contracts may remain unfunded unless and until Congress makes subsequent appropriation and the procuring agency allocates funding to the contract.

Unfunded backlog reflects our estimate of future revenue under awarded government contracts and task orders for which either funding has not yet been appropriated or expenditure has not yet been authorized. Our total backlog does not include estimates of revenue from government-wide acquisition contracts or General Services Administration schedules beyond awarded or funded task orders, but our unfunded backlog does include estimates of revenue beyond awarded or funded task orders for other types of indefinite delivery, indefinite quantity contracts based on our experience under such contracts and

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similar contracts. Unfunded backlog also includes priced options, which consist of the aggregate contract revenues expected to be earned as a result of a customer exercising an option period that has been specifically defined in the original contract award.

Contracts undertaken by us may extend beyond one year. Accordingly, portions are carried forward from one year to the next as part of backlog. Because many factors affect the scheduling of projects, no assurance can be given as to when revenue will be realized on projects included in our backlog. Although funded backlog represents only business that is considered to be firm, we cannot guarantee that cancellations or scope adjustments will not occur. The majority of funded backlog represents contracts with terms that would entitle us to all or a portion of our costs incurred and potential fees upon cancellation by the customer.

Management believes that year-to-year comparisons of backlog are not necessarily indicative of future revenues. The actual timing of receipt of revenues, if any, on projects included in backlog could change because many factors affect the scheduling of projects. In addition, cancellation or adjustments to contracts may occur. Backlog is typically subject to large variations from quarter to quarter as existing contracts are renewed or new contracts are awarded. Additionally, all U.S. Government contracts included in backlog, whether or not funded, may be terminated at the convenience of the U.S. Government.

## Liquidity and Capital Resources

As of March 29, 2015, we had cash and cash equivalents of \$34.4 million compared with cash and cash equivalents of \$34.7 million as of December 28, 2014, which includes \$12.4 million and \$12.0 million, respectively, of cash and cash equivalents held by our foreign subsidiaries. We are not presently aware of any restrictions on the repatriation of these funds; however, they are considered permanently invested in these foreign subsidiaries. If these funds were needed to fund our operations or satisfy obligations in the U.S. they could be repatriated, and their repatriation into the U.S. may cause us to incur additional U.S. income taxes or foreign withholding taxes. Any additional U.S. income taxes could be offset, in part or in whole, by foreign tax credits. The amount of such taxes and application of tax credits would be dependent on the income tax laws and other circumstances at the time these amounts are repatriated. Based on these variables, it is not practicable to determine the income tax liability that might be incurred if these earnings were to be repatriated. We do not currently intend to repatriate these earnings.

Our total debt, including capital lease obligations, principal due on our Senior Secured Notes, and other term debt remained unchanged at \$664.1 million on December 28, 2014 and March 29, 2015, as the accretion of the discount on our Senior Secured Notes was offset by the principal payment required on our 10-year term loan with the bank in Israel.

Our operating cash flow is used to finance trade accounts receivable, inventory, capital expenditures, support ongoing operations, service our debt and make strategic acquisitions. Cash from continuing operations is primarily derived from our customer contracts in progress and associated changes in working capital components. Our Days Sales Outstanding (DSOs) have increased from 104 days at December 28, 2014 to 119 days as of March 29, 2015, primarily as a result of certain contractual milestones that have not yet been attained, such as equipment shipments and deliveries on certain defense products, and for certain flight requirements that must be fulfilled on certain aerial target programs, and therefore we are unable to contractually bill for amounts outstanding related to those milestones at this time. The challenging DoD budgetary environment described above, which has in certain instances caused delays in obtaining funding necessary to proceed with payments, has impacted our DSOs as well.

A summary of our net cash provided by operating activities from continuing operations, investing activities, and financing activities from our condensed consolidated statements of cash flows is as follows (in millions):

	Three Months Ended	
	March 30, 2014	March 29, 2015
Net cash provided by (used in) operating activities from continuing operations	\$1.7	\$(2.9)
Net cash provided by (used in) investing activities	(4.7)	1.6
Net cash provided by financing activities from continuing operations	1.4	1.5
Net cash flows used in discontinued operations	(0.5)	(0.2)

Net cash provided by (used in) operating activities for the three months ended March 29, 2015 was negatively impacted by reduced operating income and changes in working capital accounts.



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Net cash provided by (used in) investing activities is primarily comprised of a decrease in restricted cash offset by capital expenditures, which consist primarily of investment in machinery, computer hardware and software and improvement of our physical properties in order to maintain suitable conditions in which to conduct our business.

Net cash provided by financing activities for the three months ended March 29, 2015 consists primarily of cash received from the Employee Stock Purchase Plan.

The cash flow from discontinued operations is related to non-core businesses we acquired in the Integral Systems Inc. acquisition.

Contractual Obligations and Commitments

Issuance of 7% Senior Secured Notes due 2019

On May 14, 2014, the Company completed an offering of \$625.0 million aggregate principal amount of 7.00% Senior Secured Notes due 2019 (the "Senior Secured Notes" or "Notes"). The proceeds from the offering, as well as borrowings of \$41.0 million from our new credit facility and cash from operations, were used to refinance the Company's existing 10% Senior Secured Notes due 2017 (the "10% Notes") and to pay all fees and expenses related thereto. The loss on the extinguishment of the 10% Notes was \$39.1 million.

The Company pays interest on the Notes semi-annually, in arrears, on May 15 and November 15 of each year. The Notes include customary covenants and events of default as well as a consolidated fixed charge ratio of 2.0:1 for the incurrence of additional indebtedness. Negative covenants include, among other things, limitations on additional debt, liens, negative pledges, investments, dividends, stock repurchases, asset sales and affiliate transactions. Events of default include, among other events, non-performance of covenants, breach of representations, cross-default to other material debt, bankruptcy, insolvency, material judgments and changes in control. As of March 29, 2015, the Company was in compliance with the covenants contained in the Indenture governing the Notes.

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

On September 17, 2014, the Company commenced an offer to exchange the outstanding Notes for an equal amount of new 7.00% Senior Secured Notes due 2019 (the "Exchange Notes") that have been registered under the Securities Act of 1933, as amended. The Company made the exchange offer pursuant to the terms of the Registration Rights Agreement, dated May 14, 2014, that it entered into with the Guarantors and the representative of the initial purchasers of the Notes. The purpose of the exchange offer was to allow holders of the Notes to exchange their Notes for Exchange Notes that are not subject to transfer restrictions. The terms of the Exchange Notes are identical in all material respects to the terms of the Notes, except the Exchange Notes have been registered under the Securities Act. The Exchange Notes are fully and unconditionally guaranteed, jointly and severally, on a senior secured basis by the Company and each of its subsidiaries, as the guarantors thereof. The Company pays interest on the Exchange Notes

semi-annually, in arrears, on May 15 and November 15 of each year. The Company completed the exchange offer on October 16, 2014, at which time the holders of all outstanding Notes had elected to exchange their Notes for Exchange Notes. The Company has no further obligations under the Registration Rights Agreement.

#### Other Indebtedness

##### \$110.0 Million Credit Facility

On May 14, 2014, the Company replaced the credit facility with KeyBank National Association and entered into a Credit and Security Agreement (the "Credit Agreement"), by and among the Company, the lenders from time to time party thereto,

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

Borrowings under the Credit Agreement may take the form of a base rate revolving loan, Eurodollar revolving loan or swingline loan. Base rate revolving loans and swingline loans will bear interest at a rate per annum equal to the sum of the applicable margin from time to time in effect plus the highest of (i) the Agent's prime lending rate, as in effect at such time, (ii) the federal funds rate, as in effect at such time, plus 0.50% per annum, and (iii) the adjusted LIBOR rate determined at such time for an interest period of one month, plus 1.00% per annum. Eurodollar revolving loans will bear interest at a rate per annum equal to the sum of the applicable margin from time to time in effect plus the adjusted LIBOR rate. The applicable margin varies between 1.50% - 2.00% for base rate revolving loans and swingline loans and 2.50% - 3.00% for Eurodollar loans, and is based on several factors including the Company's then-existing borrowing base and the Lender's total commitment amount and revolving credit exposure. The calculation of the Company's borrowing base takes into account several items relating to the Company and its subsidiaries, including amounts due and owing under billed and unbilled accounts receivables, then-held eligible raw materials inventory, work-in-process inventory, and applicable reserves. As of March 29, 2015, there was \$41.0 million outstanding on the Credit Agreement and \$13.1 million was outstanding on letters of credit, resulting in net borrowing base availability of \$38.4 million.

The Credit Agreement contains certain covenants, which include, but are not limited to, restrictions on indebtedness, liens, and investments, and places limits on other various payments, as well as a financial covenant relating to a minimum fixed charge coverage ratio of 1.15:1. The Company was in compliance with the financial covenants as of March 29, 2015.

### Debt Acquired in Acquisition

The Company has a 10-year term loan with a bank in Israel entered into on September 16, 2008 in connection with the acquisition of one of its wholly owned subsidiaries. The balance as of March 29, 2015 was \$3.5 million, and the loan is payable in quarterly installments of \$0.3 million plus interest at LIBOR plus a margin of 1.5%. The loan agreement contains various covenants, including a minimum net equity covenant as defined in the loan agreement. The Company was in compliance with all covenants, including the minimum net equity covenant, as of March 29, 2015.

### Other Liquidity Matters

We believe that our cash on hand, together with funds available under the Credit Agreement and cash expected to be generated from operating activities, will be sufficient to fund our anticipated working capital and other cash needs for at least the next 12 months.

As discussed in Part II, Item 1A, “Risk Factors” of the Form 10-K, our quarterly and annual operating results have fluctuated in the past and may vary in the future due to a variety of factors, many of which are external to our control.

If the conditions in our industry deteriorate or our customers cancel or postpone projects or if we are unable to sufficiently increase our revenues or further reduce our expenses, we may experience, in the future, a significant long-term negative impact to our financial results and cash flows from operations. In such a situation, we could fall out of compliance with our financial and other covenants, which, if not waived, could limit our liquidity and capital resources.

#### Critical Accounting Principles and Estimates

The foregoing discussion of our financial condition and results of operations is based on the condensed consolidated financial statements included in this Form 10-Q. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, sales and expenses, and the related disclosures of contingencies. We base these estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities. Actual results may differ from these estimates.

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As described in Note 1 to the Condensed Consolidated Financial Statements, we adopted Accounting Standards Update 2014-08 "Presentation of Financial Statements (Topic 205) and Property, Plant, and Equipment (Topic 360): Reporting Discontinued Operations and Disclosures of Disposals of Components of an Entity" ("ASU 2014-08") in the three month period ended March 29, 2015, which did not have a material impact on our condensed consolidated financial statements. Other than the adoption of ASU 2014-08, there have been no significant changes to our "Critical Accounting Policies or Estimates" as compared to the significant accounting policies described in the Form 10-K.

Item 3. Quantitative and Qualitative Disclosures About Market Risk.

We are exposed to market risk, primarily related to interest rates and foreign currency exchange rates.

Exposure to market risk for changes in interest rates relates to our outstanding debt. We are exposed to interest rate risk, primarily through our borrowing activities under the Credit Agreement discussed under "Contractual Obligations and Commitments" above. Based on our current outstanding balance, a 1% change in the LIBOR rate would not significantly impact our financial position. We manage exposure to these risks through our operating and financing activities and, when deemed appropriate, through the use of derivative financial instruments. Derivative financial instruments are viewed as risk management tools and are not used for speculation or for trading purposes. Derivative financial instruments would be contracted with investment grade counterparties to reduce exposure to nonperformance.

Exposure to market risk for foreign currency exchange rate risk is related to receipts from customers, payments to suppliers and intercompany loans denominated in foreign currencies. We currently enter into limited foreign currency forward contracts to manage foreign currency exchange rate risk because to date exchange rate fluctuations have had minimal impact on our operating results and cash flows.

Our cash and cash equivalents as of March 29, 2015 were \$34.4 million and are primarily invested in money market interest bearing accounts. A hypothetical 10% adverse change in the average interest rate on our money market cash investments and short-term investments would have had no material effect on our net loss for the three months ended March 29, 2015.

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### Item 4. Controls and Procedures.

#### Conclusions Regarding the Effectiveness of Disclosure Controls and Procedures

We maintain disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) promulgated under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), designed to ensure that information required to be disclosed in our reports filed under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms and that such information is accumulated and communicated to our management, including our Principal Executive Officer and Principal Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures, management recognized that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and management necessarily was required to apply its judgment in evaluating the cost benefit relationship of possible controls and procedures.

As required by Rule 13a-15(b) promulgated under the Exchange Act, we carried out an evaluation, under the supervision and with the participation of our management, including our Principal Executive Officer and Principal Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures as of the end of the period covered by this report.

Based on the foregoing, our Principal Executive Officer and Principal Financial Officer concluded that our disclosure controls and procedures were effective at the reasonable assurance level as of March 29, 2015.

#### Changes in Internal Control Over Financial Reporting

There was no change in our internal control over financial reporting during the three months ended March 29, 2015 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

## PART II. OTHER INFORMATION

### Item 1. Legal Proceedings.

See Note 10 of the Notes to the Condensed Consolidated Financial Statements contained within this Quarterly Report on Form 10-Q for a discussion of our legal proceedings.

### Item 1A. Risk Factors.

In evaluating us and our common stock, we urge you to carefully consider the risks and other information in this Quarterly Report on Form 10-Q, as well as the risk factors disclosed in Item 1A. to Part I of our Annual Report on Form 10-K for the fiscal year ended December 28, 2014, which we filed with the SEC on March 13, 2015. The risks and uncertainties described in "Item 1A - Risk Factors" of our Annual Report on Form 10-K have not materially changed.

### Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.

There were no unregistered sales of the Company's equity securities during the three month period ended March 29, 2015 that were not previously disclosed in a Current Report on Form 8-K.

Item 3. Defaults Upon Senior Securities.

None.

Item 4. Mine Safety Disclosures.

Not applicable.

Item 5. Other Information.

None

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## Item 6. Exhibits.

Exhibit Number	Exhibit Description	Incorporated by Reference		Exhibit	Filed-Furnished Herewith
		Form	Filing Date/ Period End Date		
2.1#	Agreement and Plan of Merger, dated February 7, 2011, by and among Kratos Defense & Security Solutions, Inc., Lanza Acquisition, Co. and Herley Industries, Inc. (incorporated by reference to Annex A to the Prospectus Supplement dated February 8, 2011, pursuant to the Registration Statement on Form S-3 of Kratos Defense & Security Solutions, Inc.).	424	02/08/2011(333-161340)	n/a	
2.2#	Agreement and Plan of Merger, dated May 15, 2011, by and among Kratos Defense & Security Solutions, Inc., Integral Systems, Inc., IRIS Merger Sub Inc., and IRIS Acquisition Sub LLC.	8-K	5/18/2011(001-34460)	2.1	
2.3#	Stock Purchase Agreement, dated May 8, 2012, by and among Kratos Defense & Security Solutions, Inc., Composite Engineering, Inc., and Amy Fournier, the stockholders representative.	8-K	05/08/2012(001-34460)	2.1	
3.1	Amended and Restated Certificate of Incorporation of Kratos Defense & Security Solutions, Inc.	10-Q	11/13/2001(000-27231)	4.1	
3.2	Certificate of Ownership and Merger of Kratos Defense & Security Solutions, Inc. into Wireless Facilities, Inc.	8-K	9/14/2007(000-27231)	3.1	
3.3	Certificate of Amendment to Amended and Restated Certificate of Incorporation of Kratos Defense & Security Solutions, Inc.	10-Q	11/3/2009(001-34460)	3.1	
3.4	Certificate of Designations, Preferences and Rights of Series A Preferred Stock.	10-Q	11/13/2001(000-27231)	4.2	
3.5	Certificate of Designations, Preferences and Rights of Series B Preferred Stock (included as Exhibit A to the Preferred Stock	8-K/A	6/5/2002(000-27231)	4.1	

Purchase Agreement dated as of May 16, 2002 among the Company, Meritech Capital Partners II L.P., Meritech Capital Affiliates II L.P., MCB Entrepreneur Partners II L.P., Oak Investment Partners X, Limited Partnership, Oak X Affiliates Fund, Limited Partnership, Oak Investment Partners IX, L.P, Oak Affiliates Fund, L.P, Oak IX Affiliates Fund-A, L.P, and the KLS Trust dated July 14, 1999).

3.6	Certificate of Designation of Series C Preferred Stock.	8-K	12/17/2004(000-27231)	3.1
3.7	Second Amended and Restated Bylaws of Kratos Defense & Security Solutions, Inc.	8-K	3/15/2011(001-34460)	3.1
3.8	Amendment to Second Amended and Restated Bylaws of Kratos Defense & Security Solutions, Inc.	10-Q	11/07/2014(001-34460)	3.8
4.1	Specimen Stock Certificate.	10-K	03/02/2001(001-34460)	4.1

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Exhibit Number	Exhibit Description	Incorporated by Reference		Exhibit	Filed-Furnished Herewith
		Form	Filing Date/ Period End Date		
4.2	Indenture, dated as of May 14, 2014, among Kratos Defense & Security Solutions, Inc., as Issuer, the Guarantors party thereto, and Wilmington Trust, National Association, as Trustee and Collateral Agent (including the Form of 7.00% Senior Secured Notes due 2019).	8-K	05/15/2014(000-34460)	4.1	
4.3	Registration Rights Agreement, dated as of May 14, 2014, among Kratos Defense & Security Solutions, Inc., as Issuer, the Guarantors party thereto, and SunTrust Robinson Humphrey, Inc., as Representative of the Initial Purchasers.	8-K	5/15/2014(001-34460)	10.1	
31.1	Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes Oxley Act of 2002.				*
31.2	Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes Oxley Act of 2002.				*
32.1	Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 for Eric M. DeMarco.				*
32.2	Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 for Deanna Lund.				*
101	Financial statements from the Quarterly Report on Form 10-Q of Kratos Defense & Security Solutions, Inc. for the quarter ended March 29, 2015 formatted in XBRL: (i) the Condensed Consolidated Balance Sheets, (ii) the Condensed Consolidated Statements of Operations and Comprehensive Income (Loss), (iii) the Condensed Consolidated Statements of Cash Flows, (iv) the Notes to the Condensed Consolidated Financial				*

Statements.

# Certain schedules and exhibits referenced in this document have been omitted in accordance with Item 601(b)(2) of Regulation S-K. A copy of any omitted schedule and/or exhibit will be furnished supplementally to the Securities and Exchange Commission upon request.

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

KRATOS DEFENSE & SECURITY SOLUTIONS, INC.

By: /s/ ERIC M. DEMARCO  
Eric M. DeMarco  
Chief Executive Officer, President  
(Principal Executive Officer)

By: /s/ DEANNA H. LUND, CPA  
Deanna H. Lund  
Executive Vice President, Chief Financial Officer  
(Principal Financial Officer)

By: /s/ DEBORAH BUTERA  
Deborah Butera  
Senior Vice President, General Counsel, Chief  
Compliance Officer and  
Secretary/Registered In-House Counsel

By: /s/ RICHARD DUCKWORTH  
Richard Duckworth  
Vice President and Corporate Controller  
(Principal Accounting Officer)

Date: May 7, 2015