KRATOS DEFENSE & SECURITY SOLUTIONS, INC.
Form 10-Q
August 07, 2008

QuickLinks -- Click here to rapidly navigate through this document

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

FOR THE QUARTERLY PERIOD ENDED JUNE 29, 2008

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

Commission file number 0-27231

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.)

4810 Eastgate Mall
San Diego, CA 92121
(858) 812-7300

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

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

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

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

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

As of July 31, 2008 104,955,373 shares of the registrant's common stock were outstanding

KRATOS DEFENSE & SECURITY SOLUTIONS, INC.

FORM 10-Q

FOR THE QUARTERLY PERIOD ENDED JUNE 29, 2008

INDEX

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

KRATOS DEFENSE & SECURITY SOLUTIONS, INC.

CONSOLIDATED BALANCE SHEETS

(in millions, except par value and number of shares)

(Unaudited)

	December 31, 2007	June 29, 2008
Assets		
Current assets:		
Cash and cash equivalents	$ 8.6	$ 17.4
Restricted cash		2.1
Accounts receivable, net	77.0	89.1
Income taxes receivable	1.0	0.8
Prepaid expenses	7.4	7.0
Note receivable	2.6	
Other current assets	8.7	8.9
Current assets of discontinued operations	1.6	0.7
Total current assets	106.9	126.0
Property and equipment, net	6.9	7.6
Goodwill	194.5	238.0
Other intangibles, net	19.9	25.0
Investments in unconsolidated affiliates	0.3	
Other assets	6.7	4.3
Non current assets of discontinued operations	0.1	0.3
Total assets	$ 335.3	$ 401.2
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	$ 22.7	$ 29.2
Accrued expenses	14.5	12.6
Accrued compensation	9.9	13.7
Billings in excess of costs and earnings on uncompleted contracts	10.9	9.2
Accrual for unused office space	1.0	0.7
Current portion of long-term debt	2.6	6.4
Other current liabilities	16.6	19.4
Current liabilities of discontinued operations	5.3	4.3
Total current liabilities	83.5	95.5
Long-term debt, net of current portion	72.9	76.6
Accrual for unused office space, net of current portion	1.4	0.6
Deferred tax liabilities	2.0	2.8
Other long-term liabilities	5.6	3.6
Non current liabilities of discontinued operations	2.7	2.5
Total liabilities	168.1	181.6
Commitments and contingencies (Notes 1, 5, 6, 7, 8 and 13)		
Stockholders' equity:		
Preferred Stock, 5,000,000 shares authorized, Series B Convertible Preferred Stock, $.001 par value; 10,000 shares outstanding at December 31, 2007 and June 29, 2008, (liquidation preference $5.0 million)		
Common Stock, $.001 par value, 195,000,000 shares authorized; 78,998,922 shares and 104,954,564 issued and outstanding at December 31, 2007 and June 29, 2008, respectively		
Additional paid-in capital	412.7	466.2

Accumulated deficit	(245.5)	(246.6)
Total stockholders' equity	167.2	219.6
Total liabilities and stockholders' equity	$ 335.3	$ 401.2

See accompanying notes to unaudited financial statements.

KRATOS DEFENSE & SECURITY SOLUTIONS, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS

(in millions, except per share amounts)

(Unaudited)

	Three months ended		Six months ended	
	June 30, 2007	June 29, 2008	June 30, 2007	June 29, 2008
Revenues	$ 47.8	$ 72.3	$ 96.8	$ 140.5
Cost of revenues	40.3	59.4	82.0	115.0
Gross profit	7.5	12.9	14.8	25.5
Selling, general and administrative expenses	10.8	11.2	19.9	23.1
Recovery of unauthorized issuance of stock options and adjustment to the liability for unused office space		(1.2)		(1.2)
Stock option investigation and related fees	5.0		6.5	
Operating income (loss)	(8.3)	2.9	(11.6)	3.6
Other income (expense):				
Interest expense, net		(2.5)		(4.8)
Other income, net	0.2	1.4	0.7	1.0
Total other income (expense), net	0.2	(1.1)	0.7	(3.8)
Income (loss) before income taxes	(8.1)	1.8	(10.9)	(0.2)
Provision for income taxes	0.3	0.4	0.5	0.9
Income (loss) from continuing operations	(8.4)	1.4	(11.4)	(1.1)
Income (loss) from discontinued operations	12.6	(0.6)	(4.5)	
Net income (loss)	$ 4.2	$ 0.8	$ (15.9)	$ (1.1)
Basic earnings (loss) per common share:				
Income (loss) from continuing operations	$ (0.11)	$ 0.02	$ (0.16)	(0.01)
Income (loss) from discontinued operations	0.17	(0.01)	(0.06)	
Net income (loss)	$ 0.06	$ 0.01	$ (0.22)	$ (0.01)
Diluted earnings (loss) per common share:				
Income (loss) from continuing operations	$ (0.11)	$ 0.02	$ (0.16)	$ (0.01)
Income (loss) from discontinued operations	0.17	(0.01)	(0.06)	
Net income (loss)	$ 0.06	$ 0.01	$ (0.22)	$ (0.01)
Weighted average common shares outstanding:				
Basic	73.9	80.9	73.9	79.5
Diluted	73.9	83.8	73.9	79.5

See accompanying notes to unaudited financial statements.

KRATOS DEFENSE & SECURITY SOLUTIONS, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(in millions)

(Unaudited)

	Six months ended June 30, 2007	Six months ended June 29, 2008
Operating activities:		
Net loss	$ (15.9)	$ (1.1)
Loss from discontinued operations	(4.5)	
Loss from continuing operations	(11.4)	(1.1)
Adjustments to reconcile net loss from continuing operations to net cash provided by continuing operations:		
Depreciation and amortization	2.5	3.5
Mark to market on swaps		(0.6)
Deferred income taxes	0.2	0.4
Change in accrual for unused office space		(0.6)
Stock-based compensation	0.3	0.4
Changes in assets and liabilities, net of acquisitions and divestitures:		
Accounts receivable	13.6	1.9
Prepaid expenses	(0.3)	0.8
Other assets	(5.4)	3.1
Accounts payable	(1.3)	2.6
Accrued expenses	4.3	(2.7)
Accrued compensation	(0.5)	(1.4)
Accrual for unused office space	(0.5)	(0.5)
Billings in excess of costs and earnings on uncompleted contracts	(0.6)	(2.7)
Other liabilities	1.4	0.8
Net cash provided by continuing operations	2.3	3.9
Investing activities:		
Cash paid or received in acquisitions, net	(6.2)	1.0
Decrease (increase) in restricted cash	1.0	(2.1)
Proceeds from the disposition of discontinued operations	18.6	2.3
Capital expenditures	(1.1)	(0.4)
Proceeds from the sale of investments		0.3
Net cash provided by investing activities from continuing operations	12.3	1.1
Financing activities:		
Borrowings under line of credit	8.0	5.0
Repayment under line of credit and term notes	(19.0)	(0.7)
Decrease in capital lease obligations	(0.2)	(0.1)
Net cash provided by (used in) financing activities from continuing operations	(11.2)	4.2
Net cash flows of continuing operations	3.4	9.2
Cash flows of discontinued operations		
Operating cash flows	5.0	(0.4)
Investing cash flows	(1.5)	
Net cash flows of discontinued operations	3.5	(0.4)

Net increase in cash and cash equivalents	6.9	8.8
Cash and cash equivalents at beginning of period	5.4	8.6
Cash and cash equivalents at end of period	$ 12.3	$ 17.4

See accompanying notes to unaudited financial statements.

KRATOS DEFENSE & SECURITY SOLUTIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

Note 1. Organization and Summary of Significant Accounting Policies

(a) Description of Business

Kratos Defense & Security Solutions, Inc. ("Kratos" or "the Company") was initially incorporated under the name of Wireless Facilities, Inc. in the state of New York on December 19, 1994, commenced operations in March 1995, and was reincorporated in Delaware in 1998. Under its former name of Wireless Facilities, the Company historically conducted business in three segments: Wireless Network Services, Government Network Services and Enterprise Network Services. The Company was an independent, global provider of outsourced communications and security systems engineering and integration services for the wireless communications industry through its Wireless Network Services division ("WNS"), the U.S. government through its Government Network Services division ("GNS"), and enterprise customers through its Enterprise Network Services division ("ENS").

In 2006 and 2007, the Company undertook a transformation strategy that culminated in the divestiture in 2007 of its wireless-related businesses and the Company has aggressively pursued business with the federal government, primarily the U.S. Department of Defense, through strategic acquisition. See Note 7, Acquisitions. The Company's divestiture of its European wireless engineering services business was completed in March 2007. In addition, the Company's divestiture of its domestic wireless engineering services business was completed in June 2007 and the divestiture of its wireless deployment services business was completed in July 2007. Accordingly, the accompanying financial statements reflect the divestiture of the domestic wireless engineering services and wireless network deployment business and the results of their operations through the date of divestiture as discontinued operations in the accompanying statements of operations.

As a result of the divestiture of the Company's wireless related assets and businesses in 2007, the Company changed its name from Wireless Facilities, Inc. to Kratos Defense & Security Solutions, Inc. on September 12, 2007. The name was changed to reflect the Company's revised focus as a defense contractor and security systems integrator for the federal government and for state and local agencies and reflects the Company's business going forward. Additionally, the former operating segments have been renamed as the Kratos Government Solutions ("KGS") segment, which includes all former government-related business formerly included in the GNS segment, and the Public Safety & Security ("PSS") segment, which includes all enterprise, commercial and other civilian business formerly included in the ENS segment. All financial statements prior to September 12, 2007 were issued under the Company's previous name, Wireless Facilities, Inc.

(b) Basis of Presentation

The information as of June 29, 2008, and for the three and six months ended June 30, 2007 and June 29, 2008 is unaudited. The consolidated balance sheet as of December 31, 2007 was derived from the Company's audited consolidated financial statements at that date. In the opinion of management, these unaudited consolidated financial statements include all adjustments, consisting of normal recurring adjustments, necessary for a fair presentation of the Company's financial position, results of operations and cash flows for the interim periods presented. The results have been prepared in accordance with the instructions to Form 10-Q and do not necessarily include all information and footnotes necessary for presentation in accordance with accounting principles generally accepted in the United States of America. These unaudited consolidated financial statements should be read in conjunction with the consolidated financial statements and the related notes included in the Company's

KRATOS DEFENSE & SECURITY SOLUTIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Note 1. Organization and Summary of Significant Accounting Policies (Continued)

audited annual consolidated financial statements for the year ended December 31, 2007, filed on Form 10-K on March 27, 2008 with the United States Securities and Exchange Commission ("SEC"). Interim operating results are not necessarily indicative of operating results expected in subsequent periods or for the year as a whole.

(c) Principles of Consolidation

The consolidated financial statements include the accounts of Kratos and its wholly-owned subsidiaries for which all inter-company transactions have been eliminated in consolidation. Kratos and its subsidiaries are collectively referred to herein as the "Company."

Investments in unconsolidated affiliates are accounted for using the cost method as the Company owns less than 20% and the Company has no significant influence over the affiliates.

(d) Fiscal Calendar

In 2008, the Company changed its fiscal year end to the last Sunday of the year with interim fiscal periods ending on the last Sunday of the last calendar month of each quarter. For fiscal year 2007, the Company's year end was December 31 with fiscal periods ending on the last calendar day of the last month of each quarter.

(e) Revenue Recognition

The Company provides services to customers under three primary types of contracts: fixed-price; time and materials; and cost reimbursable plus fixed fee. The Company realizes a portion of its revenue from long-term contracts and accounts for these contracts under the provisions of Statement of Position (SOP) 81-1, "Accounting for Performance of Construction-Type and Certain Production-Type Contracts." Revenue on fixed-price contracts is recognized using the percentage-of-completion method of accounting based on the ratio of total costs incurred to date compared to estimated total costs to complete the contract. Estimates of costs to complete include materials, direct labor, overhead, and allowable general and administrative expenses (for government contracts). While the Company generally does not incur a material amount of set-up fees for its projects, such costs, if any, are excluded from the estimated total costs to complete the contract and are expensed as incurred. Cost estimates are reviewed monthly on an individual 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. The full amount of an estimated loss associated with a contract is accrued and charged to operations in the period it is determined that it is probable a loss will be realized from the performance of the contract.

Significant management judgments and estimates, including the estimated costs to complete projects, which determine the project's percentage of completion and profit margin must be made and used in connection with the revenue recognized in any accounting period. In the future, the Company may realize actual results that differ from current estimates and the differences could be material.

Accordingly, the revenue the Company recognizes in a given financial reporting period depends on (1) the costs the Company has incurred for individual projects, (2) the Company's then current estimate of the total remaining costs to complete the individual projects and (3) current estimated contract value associated with the projects. If, in any period, the Company significantly increase or

KRATOS DEFENSE & SECURITY SOLUTIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Note 1. Organization and Summary of Significant Accounting Policies (Continued)

decrease the estimate of the total costs to complete a project, and/or reduce or increase the associated contract value, revenue for that period would be impacted. To the extent that the Company's estimates fluctuate over time or differ from actual results, gross margins in subsequent periods may vary significantly from previous estimates. Material differences may result in the amount and timing of the Company's revenue for any period if management made different judgments or utilized different estimates. In the event the Company is unable to provide reliable cost estimates on a given project, the Company records revenue using the completed contract method. There are no contracts for which the Company utilized the completed contract method for the periods ended June 30, 2007 and June 29, 2008.

Under the terms of substantially all of the Company's fixed price contracts, if a contract is terminated without proper cause by the customer, the customer creates unplanned/unreasonable time delays, or the customer modifies the contract tasks/scope, the Company has contractual rights to reimbursement in accordance with the terms and conditions regarding payment for work performed, but not yet billed (i.e., unbilled trade accounts receivable) at a gross profit margin that is consistent with the overall project margin. Furthermore, certain additional provisions compensate the Company for additional or excess costs incurred, whereby any scope reductions or other modifications are subject to reimbursement of costs incurred to date with a reasonable profit margin based on the contract value and completed work at that time. The inherent aforementioned risks are reflected in the Company's ongoing periodic assessment of the "total contract value" and the associated revenue recognized. Total net unbilled accounts receivable at December 31, 2007 and June 29, 2008 were $34.2 million and $44.4 million, respectively. The Company periodically performs work under authorizations to proceed or work orders from its customers for which a formal purchase order may not be received until after the work has commenced. As of December 31, 2007 and June 29, 2008, approximately $0.4 million and $0.2 million, respectively, of the Company's unbilled accounts receivable balance were under an authorization to proceed or work order from its customers where a formal purchase order had not yet been received.

Revenue from certain time and materials and fixed-price contracts are recognized when realized or realizable and earned, in accordance with Staff Accounting Bulletin (SAB) 104 (recognized when services are rendered at contracted labor rates, when materials are delivered and when other direct costs are incurred). Additionally, based on management's periodic assessment of the collectibility of its accounts receivable, credit worthiness and financial condition of customers, the Company determines if collection is reasonably assured prior to the recognition of revenue.

Cost reimbursable contracts for the government provide for reimbursement of costs plus the payment of a fee. The Company records the fee as costs are incurred. Under time and materials contracts, the Company is reimbursed for labor hours at negotiated hourly billing rates and is reimbursed for travel and other direct expenses at actual costs plus applied general and administrative expenses. Under certain of the Company's contractual arrangements, the Company may also recognize revenue for out-of-pocket expenses in accordance with EITF 01-14 "Income Statement Characterization of Reimbursements Received for Out-of-Pocket Expenses Incurred." Depending on the contractual arrangement, these expenses may be reimbursed with or without a fee.

Under certain of its contracts, the Company provides supplier procurement services and materials for its customers. The Company records revenue on these arrangements on a gross or net basis in

KRATOS DEFENSE & SECURITY SOLUTIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Note 1. Organization and Summary of Significant Accounting Policies (Continued)

accordance with EITF 99-19, "Reporting Revenue Gross as a Principal versus Net as an Agent," depending on the specific circumstances of the arrangement. The Company considers the following criteria, among others, for recording revenue on a gross or net basis:

(1) whether the Company acts as a principal in the transaction;

(2) whether the Company takes title to the products;

(3) whether the Company assumes risks and rewards of ownership, such as risk of loss for collection, delivery or returns;

(4) whether the Company serves as an agent or broker, with compensation on a commission or fee basis.

(f) Inventory

Inventories that are comprised primarily of supplies including parts and materials are stated at the lower of cost or market. The Company regularly reviews inventory quantities on hand, future purchase commitments with its suppliers, and the estimated utility of its inventory. If the Company review indicates a reduction in utility below carrying value, it reduces its inventory to a new cost basis. As of December 31, 2007 and June 29, 2008, the Company had $2.1 million and $2.7 million, respectively, of inventories which were reflected in other current assets on the Consolidated Balance Sheets.

(g) Use of Estimates

The preparation of financial statements in conformity with Generally Accepted Accounting Principles in the United States (US GAAP) requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Such estimates include revenue recognition, allowance for doubtful accounts, valuation of long-lived assets including identifiable intangibles and goodwill, accounting for income taxes including the related valuation allowance on the deferred tax asset, accruals for partial self-insurance, contingencies and litigation and contingent acquisition consideration. In the future, the Company may realize actual results that differ from the current reported estimates and if the estimates that we have used change in the future, such changes could have a material impact on the Company's consolidated financial position, results of operations and cash flows.

(h) Reclassifications

Certain prior period amounts in the Consolidated Financial Statements have been reclassified to be consistent with the current period presentation.

(i) Liquidity

The Company currently carries a significant amount of debt and as such, its ability to execute on additional business opportunities may be limited due to its existing borrowing capacity. In addition, given the relatively highly leveraged liquidity position, any down-turn in its operating earnings could impair its ability to comply with the financial covenants of its existing credit facility. If the Company anticipated a potential covenant violation, it would seek relief from its lenders. This relief would have

KRATOS DEFENSE & SECURITY SOLUTIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Note 1. Organization and Summary of Significant Accounting Policies (Continued)

some cost to the Company and such relief might not be on terms as favorable as those in its existing Credit Agreement. If the Company were to actually default due to its failure to meet the financial covenants of its Credit Agreement and inability to obtain a waiver from the lenders, the Company's Credit Agreement could require the Company to immediately repay all amounts then outstanding under the Credit Agreement and/or require the Company to pay interest at default rates per the Credit Agreement.

In the event the Company was required to repay the amount outstanding under the existing credit facility, it would need to obtain alternative sources of financing to continue its operating activities at existing levels. There can be no assurance that alternative financing would be available on acceptable terms or at all.

Note 2. Recent Accounting Pronouncements

In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements," (SFAS 157) which is effective for fiscal years beginning after November 15, 2007 and for interim periods within those years. This statement defines fair value, establishes a framework for measuring fair value and expands the related disclosure requirements. This statement applies under other accounting pronouncements that require or permit fair value measurements. The statement indicates, among other things, that a fair value measurement assumes that the transaction to sell an asset or transfer a liability occurs in the principal market for the asset or liability or, in the absence of a principal market, the most advantageous market for the asset or liability. SFAS 157 defines fair value based upon an exit price model. Relative to SFAS 157, the FASB issued FASB Staff Positions (FSP) 157-1, 157-2, and proposed 157-c. FSP 157-1 amends SFAS 157 to exclude SFAS 13 and its related interpretive accounting pronouncements that address leasing transactions, while FSP 157-2 delays the effective date of SFAS 157 for all nonfinancial assets and nonfinancial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis. FSP 157-c clarifies the principles in SFAS 157 on the fair value measurement of liabilities. The Company adopted SFAS 157 as of January 1, 2008, with the exception of the application of the statement to non-recurring nonfinancial assets and nonfinancial liabilities. Refer to Note 9 to the Condensed Consolidated Financial Statements for additional discussion on fair value measurements.

In February 2007, the FASB issued SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement No. 115," (SFAS 159) which is effective for fiscal years beginning after November 15, 2007. This statement permits entities to choose to measure many financial instruments and certain other items at fair value. This statement also establishes presentation and disclosure requirements designed to facilitate comparisons between entities that choose different measurement attributes for similar types of assets and liabilities. Unrealized gains and losses on items for which the fair value option is elected would be reported in earnings. The Company has adopted SFAS 159 as of January 1, 2008 and has elected not to measure any additional financial instruments or other items at fair value.

In December 2007, the FASB issued SFAS No. 141 (revised 2007), "Business Combinations" (SFAS 141(R)), which replaces SFAS No. 141, "Business Combinations." SFAS 141(R) retains the underlying concepts of SFAS 141 in that all business combinations are still required to be accounted for at fair value under the acquisition method of accounting, but SFAS 141(R) changed the method of

KRATOS DEFENSE & SECURITY SOLUTIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Note 2. Recent Accounting Pronouncements (Continued)

applying the acquisition method in a number of significant aspects. Acquisition costs will generally be expensed as incurred; noncontrolling interests will be valued at fair value at the acquisition date; in-process research and development will be recorded at fair value as an indefinite-lived intangible asset at the acquisition date; restructuring costs associated with a business combination will generally be expensed subsequent to the acquisition date; and any adjustments to an entity's deferred tax assets and uncertain tax positions that occur after the measurement period will be recorded as a component of income tax expense. SFAS 141(R) is effective on a prospective basis for all business combinations for which the acquisition date is on or after the beginning of the first annual period subsequent to December 15, 2008. Additionally, SFAS 141 (R) is effective for changes to valuation allowances or acquired uncertain tax positions occurring after the effective date of SFAS 141 (R), where the acquisition date occurs prior to the effective date for SFAS 141(R). Early adoption is not permitted. The Company is currently evaluating the effects, if any, that SFAS 141(R) may have on its financial statements; however, since the Company has significant acquired deferred tax assets for which full valuation allowances were recorded at the acquisition date, SFAS 141(R) could significantly affect the results of operations if changes in the valuation allowances occur subsequent to adoption. For additional discussion on deferred tax valuation allowances, refer to Note 10 to the Consolidated Financial Statements in our Annual Report filed on Form 10-K for the fiscal year ended December 31, 2007.

In December 2007, the FASB issued SFAS No. 160, "Noncontrolling Interests in Consolidated Financial Statements an amendment of ARB No. 51." This statement is effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008, with earlier adoption prohibited. This statement requires the recognition of a noncontrolling interest (minority interest) as equity in the consolidated financial statements and separate from the parent's equity. The amount of net income attributable to the noncontrolling interest will be included in consolidated net income on the face of the income statement. It also amends certain of ARB No. 51's consolidation procedures for consistency with the requirements of SFAS 141(R). This statement also includes expanded disclosure requirements regarding the interests of the parent and its noncontrolling interest. The Company is currently evaluating this new statement and anticipates that the statement will not have a significant impact on the Company's results of operations, financial condition or liquidity.

In December 2007, the EITF issued Issue No. 07-1, "Accounting for Collaborative Arrangements." This Issue is effective for financial statements issued for fiscal years beginning after December 15, 2008 and interim periods within those fiscal years, and shall be applied retrospectively to all prior periods presented for all collaborative arrangements existing as of the effective date. This Issue requires that transactions with third parties (i.e., revenue generated and costs incurred by the partners) should be reported in the appropriate line item in each company's financial statement pursuant to the guidance in EITF Issue No. 99-19, "Reporting Revenue Gross as a Principal versus Net as an Agent." This Issue also includes enhanced disclosure requirements regarding the nature and purpose of the arrangement, rights and obligations under the arrangement, accounting policy, amount and income statement classification of collaboration transactions between the parties. The Company is currently evaluating this new statement and anticipates that the statement will not have a significant impact on the Company's results of operations, financial condition or liquidity.

In March 2008, the FASB issued SFAS No. 161, "Disclosures about Derivative Instruments and Hedging Activities, an amendment of FASB Statement No. 133" (SFAS 161). This statement is

KRATOS DEFENSE & SECURITY SOLUTIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Note 2. Recent Accounting Pronouncements (Continued)

intended to improve transparency in financial reporting by requiring enhanced disclosures of an entity's derivative instruments and hedging activities and their effects on the entity's financial position, financial performance, and cash flows. SFAS 161 applies to all derivative instruments within the scope of SFAS 133, "Accounting for Derivative Instruments and Hedging Activities" (SFAS 133) as well as related hedged items, bifurcated derivatives, and nonderivative instruments that are designated and qualify as hedging instruments. Entities with instruments subject to SFAS 161 must provide more robust qualitative disclosures and expanded quantitative disclosures. SFAS 161 is effective prospectively for financial statements issued for fiscal years and interim periods beginning after November 15, 2008, with early application permitted. The Company is currently evaluating the disclosure implications of this statement and anticipates that the statement will not have a significant impact on the Company's results of operations, financial condition or liquidity.

In April 2008, the FASB issued FSP FAS No. 142-3, which amends the factors that must be considered in developing renewal or extension assumptions used to determine the useful life over which to amortize the cost of a recognized intangible asset under FAS No. 142, "Goodwill and Other Intangible Assets." The FSP requires an entity to consider its own assumptions about renewal or extension of the term of the arrangement, consistent with its expected use of the asset, and is an attempt to improve consistency between the useful life of a recognized intangible asset under FAS No. 142 and the period of expected cash flows used to measure the fair value of the asset under FAS No. 141, "Business Combinations." The FSP is effective for fiscal years beginning after December 15, 2008, and the guidance for determining the useful life of a recognized intangible asset must be applied prospectively to intangible assets acquired after the effective date. The FSP is not expected to have a significant impact on the Company's results of operations, financial condition or liquidity.

In May 2008, the FASB issued Financial Accounting Standard (FAS) No. 162, "The Hierarchy of Generally Accepted Accounting Principles." The statement is intended to improve financial reporting by identifying a consistent hierarchy for selecting accounting principles to be used in preparing financial statements that are prepared in conformance with generally accepted accounting principles. Unlike Statement on Auditing Standards (SAS) No. 69, "The Meaning of Present in Conformity With GAAP," FAS No. 162 is directed to the entity rather than the auditor. The statement is effective 60 days following the SEC's approval of the Public Company Accounting Oversight Board (PCAOB) amendments to AU Section 411, "The Meaning of Present Fairly in Conformity with GAAP," and is not expected to have any impact on the Company's results of operations, financial condition or liquidity.

In June 2008, the Financial Accounting Standards Board (FASB) issued FASB Staff Position (FSP) Emerging Issues Task Force (EITF) No. 03-6-1, "Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities." Under the FSP, unvested share-based payment awards that contain rights to receive nonforfeitable dividends (whether paid or unpaid) are participating securities, and should be included in the two-class method of computing EPS. The FSP is effective for fiscal years beginning after December 15, 2008, and interim periods within those years, and is not expected to have a significant impact on the Company's results of operations, financial condition or liquidity.

KRATOS DEFENSE & SECURITY SOLUTIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Note 3. Stockholders' Equity

The Company had the following three stock option plans under which shares were available for grant at June 29, 2008: the 1999 Equity Incentive Plan (the "1999 Plan"), the 2000 Non-Statutory Stock Option Plan (the "2000 Plan") and the 2005 Equity Incentive Plan (the "2005 Plan"). In addition, the Company has a Restricted Stock Unit Agreement (the "RSU Agreement") to govern the issuance of restricted stock units ("RSU") to executive officers under the Company's 2005 Equity Incentive Plan (the "Plan").

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

(Shares in Thousands)	Restricted Stock Units	Weighted-Average Grant-Date Fair Value
Nonvested balance, December 31, 2007	2,156	$ 2.28
Grants	760	2.05
Payments		
Cancellations/Forfeitures		
Nonvested balance, June 29, 2008	2,916	$ 2.22

The following table shows the amounts recognized in the financial statements for the three and six months ended June 30, 2007 and June 29, 2008 for share-based compensation expense related to employees (in millions, except per share data). The share-based compensation expense for the three and six months ended June 30, 2007 and June 29, 2008 primarily relates to the grant of restricted stock units. In addition, for the three and six months ended June 30, 2007 and June 29, 2008, there was no incremental tax benefit from stock options exercised in the period.

	For the Three Months Ended		For the Six Months Ended	
	June 30, 2007	June 29, 2008	June 30, 2007	June 29, 2008
Cost of revenues	$	$	$	$
Selling, general and administrative	0.1	0.2	0.3	0.4
Total cost of employee share-based compensation included in income (loss) from continuing operations, before income tax	0.1	0.2	0.3	0.4
Amount of income tax recognized in earnings				
Amount charged against income from continuing operations	0.1	0.2	0.3	0.4
Amount charged against income (loss) from discontinued operations	0.4		0.4	
Total charged against income	$ 0.5	$ 0.2	$ 0.7	$ 0.4
Total impact on net income (loss) per common share:				
Basic	$ (0.01)	$	$ (0.01)	$
Diluted	$ (0.01)	$	$ (0.01)	$

KRATOS DEFENSE & SECURITY SOLUTIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Note 3. Stockholders' Equity (Continued)

A summary of the changes in Stockholders' Equity for the periods ended June 30, 2007 and June 29, 2008 is provided below (in millions):

	Six Months Ended June 30, 2007	Six Months Ended June 29, 2008
Stockholders' equity, beginning of period	$ 187.1	$ 167.2
Stock based compensation and Employee Stock Purchase Plan	0.7	0.4
Working capital adjustment for Haverstick acquisition		1.3
Cumulative effect adjustment upon adoption of FIN No. 48	(0.1)	
Additional paid-in-capital for acquisition		51.8
Net loss	(15.9)	(1.1)
Stockholders' equity, end of period	$ 171.8	$ 219.6

The Company has two classes of stock, Series B Convertible Preferred Stock and Common Stock. There was no issuance, redemption or conversion of the Series B Convertible Preferred Stock in the most recent fiscal year ended December 31, 2007 or for the period ended June 29, 2008. Common stock issued by the Company for the most recent fiscal year ended December 31, 2007 and through the period ended June 29, 2008 was as follows: (in millions)

	Year ended December 31, 2007	Six Months Ended June 29, 2008
Shares outstanding at the beginning of the period	73.9	79.0
Common stock issued for acquisitions	4.6	26.0
Stock based compensation	0.4	
Stock options exercised	0.1	
Shares outstanding at the end of the period	79.0	105.0

The Company has an Employee Stock Purchase Plan (ESPP) which was approved in 1999 and subsequently suspended effective January 1, 2006. The Company reactivated the ESPP on April 1, 2008.

Note 4. Net Income (Loss) Per Common Share

The Company calculates net income (loss) per share in accordance with SFAS No. 128, "Earnings Per Share". Under SFAS No. 128, basic net income (loss) per common share is calculated by dividing net income (loss) by the weighted-average number of common shares outstanding during the reporting

KRATOS DEFENSE & SECURITY SOLUTIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Note 4. Net Income (Loss) Per Common Share (Continued)

period. Diluted net income (loss) per common share reflects the effects of potentially dilutive securities (in millions).

	For the Three Months Ended June 30		For the Six Months Ended June 29	
	2007	**2008**	**2007**	**2008**
Anti-dilutive weighted shares from stock options excluded from calculation	10.0	8.9	10.4	8.9
Anti-dilutive weighted shares from preferred stock excluded from calculation	1.0		1.0	1.0
Anti-dilutive weighted shares of common stock contingently issuable				2.9

Note 5. Income Taxes

The Company adopted the provisions of Financial Accounting Standards Board Interpretations (FIN) 48 on January 1, 2007. The total liability for unrecognized tax benefits as of the date of adoption was $4.7 million. Additionally, the Company has a tax refund claim of $2.4 million for which it has not recorded any benefit under FIN 48 or prior standards. As a result of the implementation of FIN 48, the Company recognized a $0.7 million increase in the liability for unrecognized tax benefits, with $0.2 million net decrease in valuation allowance, $0.1 million charged to retained earnings, and $0.4 million recorded to goodwill. In addition, the Company reduced its gross deferred tax assets by $10.8 million for unrecognized tax benefits, which was offset by a reduction in its valuation allowance by the same amount.

As of December 31, 2007, the Company had $15.2 million of unrecognized tax benefits. During the first quarter of 2008, this amount was reduced by $1.2 million relating to the expiration of statutes of limitations resulting in unrecognized tax benefits at March 31, 2008 of $14.0 million. The reduction in unrecognized tax benefits was recorded as a tax benefit from discontinued operations for $1.1 million and a reduction to goodwill for $0.1 million. As of June 29, 2008, the Company had $14.1 million of unrecognized tax benefits. The Company recognizes interest and penalties related to unrecognized tax benefits in its provision for income taxes. There were no material amounts recorded during the period ended June 30, 2007 and $0.1 million during the period ended June 29, 2008.

The Company believes that it is reasonably possible that as much as $3.1 million of the FIN 48 tax liabilities will expire within 12 months of June 29, 2008 due to the expiration of various applicable statutes of limitations and possible settlement of a pending income tax refund claim.

The negative tax rate of 450% for the six month period ended June 29, 2008 is a function of the relationship between certain minimum taxes that the Company is subject to regardless of its income.

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

KRATOS DEFENSE & SECURITY SOLUTIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Note 5. Income Taxes (Continued)

In assessing the realizability of deferred tax assets, management considers on a periodic basis, whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. As such, management has determined that it is appropriate to maintain a full valuation allowance against its deferred tax assets, with the exception of an amount equal to its deferred tax liabilities which can be expected to reverse. Management will continue to evaluate the necessity to maintain a valuation allowance against its net deferred tax asset.

Note 6. Significant Transactions

On December 28, 2006, the Board of Directors of the Company approved a plan to divest portions of the Company's business where critical mass had not been achieved. This plan involved the divestiture of the Company's EMEA (Europe, Middle East and Asia) operations and its remaining South American operations. The Company determined that these operations met the criteria to be classified as held for sale. Accordingly, these operations were reflected as discontinued in accordance with SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets" in the accompanying consolidated financial statements.

The EMEA operations were sold to LCC International, Inc. (LCC) on March 9, 2007 for $4.0 million in cash, $3.3 million of which was received on that date. The Company also received approximately $1.8 million from its EMEA operations, prior and subsequent to the closing date as payment on outstanding intercompany debt. The sale of EMEA generated a gain on disposition of $3.3 million. The balance of the $0.7 million sales price was withheld as security for the satisfaction of certain indemnification obligations and was payable on March 31, 2008. In the fourth quarter of 2007, the Company recorded a reserve of $0.7 million on the remaining sales price holdback based on the Company's assessment of LCC's available liquidity and ability to pay following the Company's review of LCC's most recently filed financial statements, thereby reducing the net estimated gain on this transaction to $2.6 million. In May 2008, the Company and LCC reached an agreement related to the $0.7 million holdback amount, under which LCC has agreed to pay the Company the outstanding balance in $100,000 increments each month commencing June 30, 2008. The Company did not receive the payments due on June 30, 2008 or July 31, 2008. While the Company intends to vigorously pursue collection of the amounts, there is a substantial likelihood the Company will not receive payment of the amount due in light of LCC's apparent current available liquidity.

On April 20, 2007, the Company entered into an Equity Purchase Agreement to sell all of the issued and outstanding equity of its interests of its wholly owned subsidiary WFI Brazil Techlogia en Telecomunicaciones LTDA, to Strategic Project Services, LLC (SPS). The consideration included the assumption of substantially all outstanding liabilities of WFI Brazil, nominal cash consideration, and additional earn-out consideration based on 25 percent of net receivables collected subsequent to the closing date. With respect to the additional earn-out consideration, the Company has not received and does not expect to receive any payments. The Company recorded an impairment charge of approximately $5.2 million as of December 31, 2006 to reduce the current carrying value of the Brazil operations to their estimated fair value based upon indications of interest at that time.. In the second quarter of 2007, when this business was sold, a gain on disposition of $0.2 million was recorded primarily due to lower than expected selling costs.

KRATOS DEFENSE & SECURITY SOLUTIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Note 6. Significant Transactions (Continued)

On May 29, 2007, the Company entered into an Asset Purchase Agreement with LCC pursuant to which the Company agreed to sell to LCC all of the assets used in the conduct of the operation of the Company's Wireless Network Services business segment that provides engineering services to the non-government wireless communications industry in the United States.

The transaction was completed on June 4, 2007. The aggregate consideration paid by LCC in connection with the Acquisition was $46 million. LCC delivered a subordinated promissory note for the principal amount of $21.6 million (the "*Subordinated Promissory Note*"), paid $17 million at closing and paid final working capital adjustments of $2.4 million through an amendment to the Subordinated Promissory Note, and the Company retained an estimated $5.0 million in net working capital of the business.

On July 5, 2007, the Company sold the $21.6 million subordinated promissory note taken in the sale of assets to LCC in exchange for approximately $19.6 million in net cash proceeds, reflecting a discount from par value of less than five percent and aggregate transaction fees of approximately $1 million. The note was acquired by a fund affiliated with Silver Point Capital, L.P. The Company collected $2.3 million in January 2008, net of a $0.1 million discount from Silver Point in accordance with the terms of the note agreement for the working capital portion of the note. The Company did not provide any guaranty for LCC's payment obligations for the note.

On July 24, 2007, the Company completed the sale to an affiliate of Platinum Equity of its wireless deployment services portion of the Wireless Network Services segment and the Wireless Facilities trade and corporate names. The total consideration for the acquisition was $24 million including $18 million in cash at closing, subject to typical post-closing working capital adjustments, and an aggregate $6 million in a three-year earn-out arrangement. The Company provided certain transition services to Platinum Equity for a period of nine months pursuant to a Transition Services Agreement. Under an employee leasing arrangement with Platinum Equity, the Company serviced the payroll for the deployment business employees until October 1, 2007. On September 25, 2007, in accordance with the acquisition agreement, the Company provided its working capital calculation to Platinum Equity. On July 16, 2008, the Company came to an agreement with Platinum Equity on a working capital adjustment of $5.0 million. In connection with that resolution, the earn-out arrangement was terminated. The adjustment is to be paid in installments with the first amount of $2.5 million due on July 31, 2008 and payments of $0.5 million monthly thereafter until paid in full in December 2008. As of June 29, 2008, the balance of $5.0 million has been reflected in other current liabilities. As of August 6, 2008, the $2.5 million initial payment had not been made.

The Company determined that the U.S. engineering and U.S. deployment operations met the criteria to be classified as held for sale in the first quarter of 2007. Accordingly, the Company has reflected these operations as discontinued and assessed these assets for impairment in accordance with SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets". The Company determined that the assets of the U.S. deployment operations were impaired and recorded an impairment charge of approximately $13.4 million. The fair value of the assets was determined by utilizing the sale price less estimated costs to sell the business. The Company subsequently recorded a gain in discontinued operations from the sale of the U.S. engineering operations of $14.8 million. Upon the divestiture of the deployment business, the Company recorded a loss from disposal of $1.9 million, reflecting the closing working capital adjustment and final closing balance sheet. In addition, the

KRATOS DEFENSE & SECURITY SOLUTIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Note 6. Significant Transactions (Continued)

Company recorded a charge for an excess facility accrual of approximately $1.1 million related to certain facility leases of deployment field offices that were not assumed by Platinum.

The determination that the U.S. engineering business and U.S. deployment operations met the criteria to be classified as held for sale in the first quarter of 2007 was also a triggering event under SFAS 142 Goodwill and Other Intangible Assets ("SFAS 142") that resulted in an accelerated review of the Company's goodwill and intangibles assets with indefinite lives. In accordance with SFAS 142, the Company allocated the goodwill for the WNS reporting unit based upon the fair value of the engineering business and the deployment business. The fair values used were based upon market information obtained as a result of the sale of the businesses. This resulted in an impairment charge of approximately $7.2 million related to goodwill for this reporting unit which was recorded in the first quarter of 2007.

In addition, in accordance with EITF 87-24, *Allocation of Interest to Discontinued Operations* ("EITF 87-24"), interest expense incurred on the debt that was required to be repaid as a result of the sales of our wireless network services business was allocated to discontinued operations for the periods presented. During the quarter ended June 30, 2007 and June 29, 2008, interest expense allocated to discontinued operations was approximately $1.0 million and zero, respectively. For the six months ended June 30, 2007 and June 29, 2008, interest expense allocated to discontinued operations was approximately $2.1 million and zero, respectively. For the six months ended June 29, 2008, the primary activity related to discontinued operations was a reduction in tax contingencies net of a charge for impairment of assets and the adjustment related to the agreement of the working capital with Platinum Equity. The following table presents the results of discontinued operations (in millions):

	For the Three Months Ended		For the Six Months Ended June 30	
	June 30, 2007	June 29, 2008	June 30, 2007	June 29, 2008
Revenue	$ 32.6	$	$ 79.6	$
Net income (loss) before taxes	$ 12.6	$ (0.4)	$ (5.6)	$ (0.9)
Provision (benefit) for income taxes		0.2	(1.1)	(0.9)
Net income (loss) after taxes	$ 12.6	$ (0.6)	$ (4.5)	$

KRATOS DEFENSE & SECURITY SOLUTIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Note 6. Significant Transactions (Continued)

The following is a summary of the assets and liabilities of discontinued operations as of December 31, 2007 and June 29, 2008 (in millions):

	December 31, 2007		June 29, 2008	
Cash	$	0.3	$	0.2
Accounts receivable, net		0.8		
Other current assets		0.5		0.5
Current assets of discontinued operations	$	1.6	$	0.7
Other non-current assets	$	0.1	$	0.3
Non-current assets of discontinued operations	$	0.1	$	0.3
Accounts payable	$		$	0.1
Accrued expenses		3.7		3.2
Income tax contingencies				