

DRS TECHNOLOGIES INC  
Form 10-Q  
August 08, 2008

[QuickLinks](#) -- Click here to rapidly navigate through this document

**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 **June 30, 2008**

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

For the transition period from \_\_\_\_\_ to  
Commission file number **1-8533**

**DRS Technologies, Inc.**

(Exact name of registrant as specified in its charter)

**Delaware**  
(State or other jurisdiction  
of incorporation or organization)

**13-2632319**  
(IRS Employer  
Identification No.)

**5 Sylvan Way, Parsippany, New Jersey 07054**  
(Address of principal executive offices)

**(973) 898-1500**

(Registrant's telephone number, including area code)

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

Large accelerated filer <input checked="" type="radio"/>	Accelerated filer <input type="radio"/>	Non-accelerated filer <input type="radio"/>	Smaller reporting company <input type="radio"/>
---	--	--	--

## Edgar Filing: DRS TECHNOLOGIES INC - Form 10-Q

(Do not check if a  
smaller reporting  
company)

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

There were 41,456,234 shares of DRS Technologies, Inc. common stock with a par value of \$0.01 outstanding as of the close of business on August 4, 2008.

---

**DRS TECHNOLOGIES, INC. AND SUBSIDIARIES**  
**Index to Quarterly Report on Form 10-Q**  
**for the Quarter Ended June 30, 2008**

		<b>Page</b>
<b>PART I FINANCIAL INFORMATION</b>		
Item 1.	Financial Statements (Unaudited)	
	Consolidated Balance Sheets June 30, 2008 and March 31, 2008	1
	Consolidated Statements of Earnings Three Months Ended June 30, 2008 and 2007	2
	Consolidated Statements of Cash Flows Three Months Ended June 30, 2008 and 2007	3
	Notes to the Consolidated Financial Statements	4
Item 2.	Management's Discussion and Analysis of Financial Condition and Results of Operations	32
Item 3.	Quantitative and Qualitative Disclosure about Market Risk	46
Item 4.	Controls and Procedures	46
<b>PART II OTHER INFORMATION</b>		
Item 1.	Legal Proceedings	48
Item 1A.	Risk Factors	51
Item 5.	Other Information	51
Item 6.	Exhibits	52
	Signatures	53

---

## PART I FINANCIAL INFORMATION

## Item 1. Financial Statements

## DRS TECHNOLOGIES, INC. AND SUBSIDIARIES

Consolidated Balance Sheets  
(in thousands, except share and per-share data)

(Unaudited)

	June 30, 2008	March 31, 2008
<b>Assets</b>		
Current assets		
Cash and cash equivalents	\$ 59,859	\$ 86,251
Accounts receivable, net of allowance for doubtful accounts of \$2,809 and \$2,819 as of June 30, 2008 and March 31, 2008, respectively	547,890	574,129
Inventories, net	485,762	437,709
Prepaid expenses, deferred income taxes and other current assets	132,678	127,466
<b>Total current assets</b>	<b>1,226,189</b>	<b>1,225,555</b>
Property, plant and equipment, less accumulated depreciation of \$232,739 and \$220,986 at June 30, 2008 and March 31, 2008, respectively	259,879	255,677
Acquired intangible assets, net	160,458	167,774
Goodwill	2,622,421	2,624,589
Deferred income taxes and other noncurrent assets	43,955	42,440
<b>Total assets</b>	<b>\$4,312,902</b>	<b>\$4,316,035</b>
<b>Liabilities and Stockholders' Equity</b>		
Current liabilities		
Short-term borrowings and current installments of long-term debt	\$ 350,412	\$ 5,384
Accounts payable	312,328	357,859
Accrued expenses and other current liabilities	516,601	507,550
<b>Total current liabilities</b>	<b>1,179,341</b>	<b>870,793</b>
Long-term debt, excluding current installments	1,281,473	1,627,468
Other liabilities	127,901	134,168
<b>Total liabilities</b>	<b>2,588,715</b>	<b>2,632,429</b>
Commitments and Contingencies		
Stockholders' equity		
Preferred stock, \$10 par value per share. Authorized 2,000,000 shares; none issued at June 30, 2008 and March 31, 2008		
Common Stock, \$.01 par value per share. Authorized 100,000,000 shares; 41,440,998 and 41,373,509 shares issued at June 30, 2008 and March 31, 2008, respectively	414	414
Additional paid-in capital	1,136,663	1,129,924
Retained earnings	570,550	537,130
Accumulated other comprehensive earnings	16,560	16,138

Edgar Filing: DRS TECHNOLOGIES INC - Form 10-Q

<b>Total stockholders' equity</b>	1,724,187	1,683,606
<b>Total liabilities and stockholders' equity</b>	\$4,312,902	\$4,316,035

See accompanying Notes to the Consolidated Financial Statements.

**DRS TECHNOLOGIES, INC. AND SUBSIDIARIES**  
**Consolidated Statements of Earnings**  
(in thousands, except per-share data)  
(Unaudited)

	Three Months Ended June 30,	
	2008	2007 (Restated)
<b>Revenues:</b>		
Products	\$721,196	\$ 536,825
Services	230,670	198,805
<b>Total revenues</b>	951,866	735,630
<b>Costs and expenses:</b>		
Products	650,855	482,126
Services	213,315	185,326
Merger-related expenses (Note 1)	11,547	
<b>Total costs and expenses</b>	875,717	667,452
<b>Operating income</b>	76,149	68,178
Interest income	300	559
Interest and related expenses	23,471	28,710
Other expense, net	240	70
<b>Earnings before noncontrolling interests and income taxes</b>	52,738	39,957
Noncontrolling interests	414	493
<b>Earnings before income taxes</b>	52,324	39,464
Income taxes	16,919	14,260
<b>Net earnings</b>	\$ 35,405	\$ 25,204
<b>Net earnings per share of common stock:</b>		
Basic earnings per share:	\$ 0.87	\$ 0.62
Diluted earnings per share:	\$ 0.83	\$ 0.61
<b>Dividends per common share</b>	\$ 0.03	\$ 0.03

See accompanying Notes to the Consolidated Financial Statements.

**DRS TECHNOLOGIES, INC. AND SUBSIDIARIES**  
**Consolidated Statements of Cash Flows**  
(in thousands)

(Unaudited)

	Three Months Ended June 30,	
	2008	2007 (Restated)
<b>Cash Flows from Operating Activities</b>		
Net earnings	\$ 35,405	\$ 25,204
Adjustments to reconcile net earnings to cash flows from operating activities:		
Depreciation and amortization	19,730	18,513
Share-based compensation	3,616	2,228
Deferred income taxes	(1,581)	10,292
Inventory reserve and provision for doubtful accounts	789	202
Amortization and write-off of deferred financing fees	1,514	1,623
Other, net	(600)	(85)
Changes in assets and liabilities:		
Decrease in accounts receivable	26,340	20,409
Increase in inventories	(48,625)	(23,470)
(Increase) decrease in prepaid expenses and other current assets	(2,993)	4,151
Decrease in accounts payable	(42,833)	(59,246)
Decrease in accrued expenses and other current liabilities	(14,791)	(12,723)
Increase in customer advances	24,134	14,862
Decrease in pension and postretirement benefit liabilities	(7,131)	(1,252)
Other, net	(849)	(181)
<b>Net cash (used in) provided by operating activities</b>	(7,875)	527
<b>Cash Flows from Investing Activities</b>		
Capital expenditures	(19,691)	(13,893)
Disposition of property, plant and equipment	1	4
<b>Net cash used in investing activities</b>	(19,690)	(13,889)
<b>Cash Flows from Financing Activities</b>		
Borrowings on revolving line of credit	115,000	90,000
Repayments of revolving line of credit	(115,000)	(90,000)
Borrowings of short-term debt	118	
Borrowings of long-term debt	580	
Repayments of long-term debt	(1,349)	(51,317)
Excess tax benefit realized from share-based payment arrangements	706	1,413
Proceeds from stock option exercises	2,013	2,664
Dividends paid	(1,225)	(1,213)
Other	200	3
<b>Net cash provided by (used in) financing activities</b>	1,043	(48,450)
<b>Effect of exchange rates on cash and cash equivalents</b>	130	92
<b>Net decrease in cash and cash equivalents</b>	(26,392)	(61,720)
<b>Cash and cash equivalents, beginning of period</b>	86,251	95,833
<b>Cash and cash equivalents, end of period</b>	\$ 59,859	\$ 34,113

See accompanying Notes to the Consolidated Financial Statements.





**DRS TECHNOLOGIES, INC. AND SUBSIDIARIES**

**Notes to the Consolidated Financial Statements**

**(Unaudited)**

**1. Description of Business**

DRS Technologies, Inc., its wholly-owned subsidiaries and its controlling interests (hereinafter, DRS or the Company) is a supplier of defense electronic products, systems and military support services. The Company provides high-technology products and services to all branches of the U.S. military, major aerospace and defense prime contractors, government intelligence agencies, international military forces and industrial markets. The Company focuses on several key areas of importance for the U.S. Department of Defense (DoD), such as intelligence, surveillance, reconnaissance, power management, advanced communications and network systems. DRS is a provider of thermal imaging devices, combat display workstations, electronic sensor systems, power systems, battlefield digitization systems, air combat training systems, mission recorders, deployable flight incident recorders, environmental and telecommunication systems, aircraft loaders, military trailers and shelters. The Company also provides support services, including security and asset protection system services, telecommunication and information technology services, training and logistics support services for all branches of the U.S. armed forces, certain foreign militaries, homeland security forces and selected government and intelligence agencies.

On May 12, 2008, DRS announced that it had signed a definitive merger agreement under which Finmeccanica, S.p.A. (Finmeccanica) will, subject to certain conditions set forth in the merger agreement, acquire 100% of DRS stock for \$81.00 per share in cash. The merger agreement provides for, among other things, the merger of a subsidiary of Finmeccanica with and into the Company with the Company as the surviving corporation and becoming a wholly-owned subsidiary of Finmeccanica.

The transaction is subject to approval by the stockholders of DRS, the receipt of regulatory approvals and other closing conditions, including review by U.S. antitrust authorities, the Committee on Foreign Investment in the United States (CFIUS) and the Defense Security Service (DSS). The transaction is expected to close in the fourth quarter of 2008. In the three months ended June 30, 2008, the Company incurred \$11.5 million in investment banking, legal and consulting expenses related to the pending merger.

**2. Basis of Presentation**

The accompanying unaudited consolidated financial statements include all wholly-owned and majority-owned subsidiaries and controlling interests of DRS. The financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America and with the instructions to Form 10-Q and Article 10 of Regulation S-X. In the opinion of the Company, the interim consolidated financial information provided herein reflects all adjustments (consisting of normal and recurring adjustments) necessary for a fair presentation of the Company's consolidated financial position as of June 30, 2008, the results of its operations for the three-month periods ended June 30, 2008 and 2007, and its cash flows for the three-month periods ended June 30, 2008 and 2007. The results of operations and cash flows for the interim period ended June 30, 2008 are not necessarily indicative of the results to be expected for the full year. These interim consolidated financial statements should be read in conjunction with the consolidated financial statements of the Company for the fiscal year ended March 31, 2008, which are included in the Company's filing on Form 10-K for the year ended March 31, 2008.

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect

**DRS TECHNOLOGIES, INC. AND SUBSIDIARIES**

**Notes to the Consolidated Financial Statements (Continued)**

**(Unaudited)**

**2. Basis of Presentation (Continued)**

the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and costs and expenses during the reporting period. The most significant of these estimates and assumptions relate to contract revenue, costs to complete performance on a contract, profit and loss recognition, fair values of assets acquired and liabilities assumed in business combinations, market values for inventories reported at lower of cost or market, pension and postretirement benefit obligations, share-based employee compensation costs, recoverability, useful lives and valuation of recorded amounts of long-lived assets, identifiable intangible assets and goodwill, income taxes, including the valuation of deferred tax assets and liabilities, the valuation of unrecognized tax benefits, litigation reserves and environmental obligations. Changes in estimates are reflected in the periods during which they become known. Actual amounts will differ from these estimates and could differ materially. For a more complete discussion of these estimates and assumptions, see the Annual Report of DRS Technologies, Inc. on Form 10-K for the fiscal year ended March 31, 2008.

The fiscal year-end consolidated balance sheet data was derived from the Company's audited financial statements, but does not include all disclosures required by accounting principles generally accepted in the United States of America. Certain fiscal 2008 amounts have been reclassified to conform to the fiscal 2009 presentation.

**3. Restatement of Previously Issued Consolidated Financial Statements**

In February 2008, the Company received a comment letter from the staff of the SEC on its fiscal 2007 Form 10-K (filed on May 30, 2007) and its fiscal 2008 second quarter Form 10-Q (filed on November 9, 2007). In the initial comment letter, and in other subsequent written and telephonic communications with the staff of the SEC, information was requested regarding the timing of a \$36.8 million pretax charge that was recorded in the Company's fiscal 2008 first quarter ended June 30, 2007 for the impact of a redesign on the Company's Thermal Weapon Sight II (TWS II) program. Following discussions with the staff of the SEC and review of the judgments and estimates the Company made relating to the charge, the Company concluded that the \$36.8 million charge should have been recorded in the Company's fiscal 2007 fourth quarter ended March 31, 2007.

As a result of the foregoing, the Company restated in its March 31, 2008 Form 10-K its previously filed consolidated financial statements for the year ended March 31, 2007, inclusive of the Company's fourth quarter ended March 31, 2007 and the previously issued quarterly consolidated financial statements for the three-month period ended June 30, 2007.

## DRS TECHNOLOGIES, INC. AND SUBSIDIARIES

## Notes to the Consolidated Financial Statements (Continued)

(Unaudited)

## 3. Restatement of Previously Issued Consolidated Financial Statements (Continued)

The following table sets forth the effects of the restatement adjustment on the consolidated statement of earnings for the quarter ended June 30, 2007.

	Quarter Ended June 30, 2007		
	As Previously Reported	Adjustment	As Restated
	(in thousands except per-share amounts)		
<b>Consolidated Statement of Earnings:</b>			
Costs and expenses Products	\$ 518,970	\$ (36,844)	\$482,126
Total costs and expenses	\$ 704,296	\$ (36,844)	\$667,452
Operating income	\$ 31,334	\$ 36,844	\$ 68,178
Earnings before noncontrolling interests and income taxes	\$ 3,113	\$ 36,844	\$ 39,957
Earnings before income taxes	\$ 2,620	\$ 36,844	\$ 39,464
Income taxes	\$ 970	\$ 13,290	\$ 14,260
Net earnings	\$ 1,650	\$ 23,554	\$ 25,204
Basic earnings per share	\$ 0.04	\$ 0.58	\$ 0.62
Diluted earnings per share	\$ 0.04	\$ 0.57	\$ 0.61

The restatement adjustment did not affect the reported amounts of net cash provided by operating activities, net cash used in investing activities, and net cash used in financing activities for the three months ended June 30, 2007.

As a result of the adjustment discussed above, modifications were required to previously filed footnotes: Notes 6, 10, 11, 13 and 18.

## 4. Income Taxes

The provision for income taxes for the three months ended June 30, 2008 reflected an effective income tax rate of approximately 32.3%, as compared with 36.1% in the same period last year. The Company's effective tax rate decreased primarily due to a favorable settlement with the Internal Revenue Service (IRS), concerning its examination of our federal tax returns for the years ended March 31, 2002 through 2004, partially offset by an increase due to the scheduled expiration of the research & development credit.

As a result of the audit, the Company paid approximately \$5.5 million, which included interest of approximately \$1.3 million, and recorded a discrete tax benefit of approximately \$2.5 million, an adjustment to goodwill of approximately \$2.5 million, an adjustment to additional paid in capital of \$0.1 million and the remainder impacting deferred tax assets, deferred tax liabilities and income taxes payable.

## DRS TECHNOLOGIES, INC. AND SUBSIDIARIES

## Notes to the Consolidated Financial Statements (Continued)

(Unaudited)

**4. Income Taxes (Continued)**

A reconciliation of the change in our unrecognized tax benefits for the three months ended June 30, 2008 follows:

Balance as of April 1, 2008	\$29,154
Increase related to current year positions	\$ 327
Decrease due to changes in prior year positions	\$ 8,018
Decrease due to settlements with taxing authorities	\$ 4,228
Balance as of June 30, 2008	\$17,235

The Company operates in multiple taxing jurisdictions, both within the United States and outside of the United States, and faces audits from various tax authorities regarding transfer pricing, the deductibility of certain costs and intercompany transactions, as well as other matters. At June 30, 2008, the total amount of the liability for unrecognized tax benefits related to federal, state and foreign income tax matters was approximately \$17.2 million. Upon settlement of the Company's unrecognized tax benefits, approximately \$7.9 million would impact goodwill and additional paid-in-capital, if recognized, and \$9.3 million would impact our effective tax rate, if recognized. Additionally, the impact of accrued interest on unrecognized tax benefits would be \$1.3 million, if recognized.

Based upon the expiration of statutes of limitations and/or the conclusion of tax examinations in several jurisdictions, the Company believes it is reasonably possible that the total amount of previously unrecognized tax benefits for the items discussed above may decrease by up to \$3.0 million within 12 months of June 30, 2008.

**5. Share-Based Compensation**

In the three months ended June 30, 2008 and 2007, the Company recorded total share-based costs related to stock options and non-vested stock of \$3.7 million and \$2.7 million, respectively. Such amounts were recognized in the consolidated financial statements as follows:

	Three Months Ended June 30,	
	2008	2007
Total cost of share-based payment plans	\$ 3,690	\$ 2,689
Amounts capitalized in inventory	(2,534)	(1,374)
Amounts charged against earnings for amounts previously capitalized in inventory	2,460	913
Amounts charged against earnings before income tax benefit	\$ 3,616	\$ 2,228

## DRS TECHNOLOGIES, INC. AND SUBSIDIARIES

## Notes to the Consolidated Financial Statements (Continued)

(Unaudited)

## 5. Share-Based Compensation (Continued)

**Stock Options** The following table summarizes information regarding the Company's stock option activity and amounts as of and for the three months ended June 30, 2008.

	Number of Options	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (years)	Aggregate Intrinsic Value (in thousands)
Outstanding at March 31, 2008	2,152,418	\$ 36.54		
Granted				
Exercised	(69,603)	\$ 29.15		
Cancelled/forfeited	(1,500)	\$ 37.29		
Outstanding at June 30, 2008	2,081,315	\$ 36.79	5.81	\$ 87,266
Vested and expected to vest at June 30, 2008(1)	2,071,055	\$ 36.72	5.80	\$ 86,974
Exercisable at June 30, 2008	1,677,227	\$ 34.11	5.29	\$ 74,824

(1)

Represents outstanding options reduced by expected forfeitures.

The aggregate intrinsic values, disclosed in the table above, represent the difference between DRS's closing stock price on the last trading day of the first quarter (June 30, 2008) and the exercise price, multiplied by the number of in-the-money stock options for each category.

The total intrinsic values of stock options exercised, based on the difference between DRS's stock price at the time of exercise and the related exercise price, during the three-month periods ended June 30, 2008 and 2007 was \$2.7 million and \$4.7 million, respectively. Total compensation cost related to stock options was \$1.2 million and \$1.3 million for the three-month periods ended June 30, 2008 and 2007, respectively. At June 30, 2008, unrecognized compensation costs related to stock options was \$6.1 million (\$3.7 million after income taxes), which is expected to be recognized over a weighted average remaining period of 1.2 years.

The estimated weighted average grant date fair value of each stock option awarded was \$21.00 for the three-month period ended June 30, 2007. There were no stock option grants in the three-month period ended June 30, 2008.

**Non-Vested Stock and Non-Vested Stock Units** Non-vested stock is granted to certain employees, as permitted under the 2006 Omnibus Plan in the name of the employee, who has all the rights of a stockholder, subject to certain restrictions. Non-vested stock units are granted in the name of the employee; however, the participant has no rights as a stockholder. These non-vested stock units are redeemed for DRS common stock once a three-year cliff vesting period has been satisfied. The cost of the grants, as determined by the market prices of the common stock at the grant dates, net of expected forfeitures, is recognized over the vesting periods.

Compensation cost for non-vested stock awards for the three months ended June 30, 2008 and 2007 was \$2.5 million and \$1.4 million, respectively. As of June 30, 2008, total unrecognized compensation costs related to non-vested stock awards was \$13.9 million (\$8.4 million after income



## DRS TECHNOLOGIES, INC. AND SUBSIDIARIES

## Notes to the Consolidated Financial Statements (Continued)

(Unaudited)

## 5. Share-Based Compensation (Continued)

taxes), and that amount is expected to be recognized over a weighted average remaining period of 1.8 years.

The following table details the activity in non-vested stock awards for the three months ended June 30, 2008.

		Three Months Ended June 30, 2008	
		Number of Shares	Weighted Average Grant Date Fair Value per Share
Nonvested	Balance at March 31, 2008	602,875	\$ 51.94
	Granted	1,911	\$ 78.48
Vested			
	Forfeited/cancelled	(4,025)	\$ 52.20
Nonvested	Balance at June 30, 2008	600,761	\$ 52.02

## 6. Inventories

Inventories are summarized as follows:

	June 30, 2008	March 31, 2008
	(in thousands)	
Work-in-process	\$575,192	\$550,323
General and administrative costs	57,280	64,521
Raw material and finished goods	55,387	61,961
	687,859	676,805
Less: Progress payments and certain customer advances	193,301	231,093
Inventory reserve	8,796	8,003
Total	\$485,762	\$437,709

Inventoried contract costs for the Company's businesses that are primarily government contractors include certain general and administrative (G&A) costs, including internal research and development (IRAD) costs and bid and proposal (B&P) costs. G&A, IRAD and B&P costs are allowable, indirect contract costs under U.S. government regulations. The Company allocates these costs to government contracts and accounts for them as product costs, not as period expenses, at the majority of the Company's operating units.

Total expenditures for internal research and development amounted to approximately \$16.6 million and \$11.5 million for the three-month periods ended June 30, 2008 and 2007, respectively.

The Company bifurcates its total G&A costs into "allowable" and "unallowable" cost pools, as the terms are defined in the U.S. Federal Acquisition Regulations (FAR) procurement regulations. The Company accounts for allowable G&A costs allocated to its government contractor operating units that design, develop and produce complex defense electronic components and systems for specifically





## DRS TECHNOLOGIES, INC. AND SUBSIDIARIES

## Notes to the Consolidated Financial Statements (Continued)

(Unaudited)

## 6. Inventories (Continued)

identified contracts as contract costs because such costs are generally reimbursable indirect contract costs pursuant to the terms of the contracts. The Company expenses such allowable G&A costs as a component of costs and expenses when the revenues related to those contracts are recognized.

The Company's government contractor operating units allocate allowable G&A costs to contracts using an indirect overhead rate, which generally is based upon allowable G&A costs as a percentage of a total cost (direct labor, manufacturing overhead, raw material and other direct costs) input base.

The Company believes that accounting for allowable G&A costs as contract costs is consistent with industry practice and supported by authoritative accounting literature as outlined in the American Institute of Certified Public Accountants (AICPA) Statement of Position 81-1, Accounting for Performance of Construction-Type and Certain Production-Type Contracts (SOP 81-1), the AICPA Audit and Accounting Guide, Audits of Federal Government Contractors, and Chapter 4 of Accounting and Research Bulletin (ARB) 43, Restatement and Revision of Accounting Research Bulletins.

The Company expenses "unallowable" G&A costs allocable to its government contractor operating units as they are incurred (i.e., period expense) because unallowable costs, as defined in the FAR, are not reimbursable under government contracts. All G&A costs allocated to the Company's non-government contractor operating units are expensed as incurred.

The table below presents a summary of G&A, IRAD and B&P costs included in inventoried contract costs and changes to them, including amounts used in the determination of costs and expenses. The cost data in the table below does not include the G&A, IRAD and B&P costs for the Company's non-government contractor operating units, which are expensed as incurred:

	Three Months Ended June 30,	
	2008	2007 (Restated)
	(in thousands)	
Balance in inventory at beginning of period	\$ 64,521	\$ 60,485
Add: Incurred costs	113,679	79,214
Less: Amounts included in costs and expenses	(120,920)	(70,623)
Balance in inventory at end of period	\$ 57,280	\$ 69,076

General and administrative expenses related to the Company's non-government contractor operating units amounted to \$56.6 million and \$42.7 million for the three-month periods ended June 30, 2008 and 2007, respectively.

During the fourth quarter of fiscal 2007, the Company recorded a \$40.3 million charge to operations for an anticipated loss on the Thermal Weapon Sight II (TWS II) program. The most significant component of the charge was a result of the estimated cost of new material following recent design modifications, as well as the write-off of certain inventory. As a result of the design changes, the Company also transferred \$30.0 million of saleable product and components from the TWS II program (transferred inventory) to inventory during the fourth quarter of fiscal 2007, which is valued at the lower of cost or market as of June 30, 2008 and March 31, 2008.

## DRS TECHNOLOGIES, INC. AND SUBSIDIARIES

## Notes to the Consolidated Financial Statements (Continued)

(Unaudited)

## 6. Inventories (Continued)

The Company believes that the transferred inventory will be sold primarily through international distribution channels. The sale of certain products outside of the United States is highly regulated, and any inability to obtain the requisite licenses or comply with applicable government export regulations may affect the Company's ability to export the transferred inventory. If the Company is precluded from selling the transferred inventory to certain international customers and/or is unable to generate sufficient domestic revenues, the value of the transferred inventory may be required to be written down or written off in a future period. Such a write-down or write-off could be material to the results of operations in any one period. As of June 30, 2008 and March 31, 2008, approximately \$21.3 million, of transferred inventory and components remained with the Company.

## 7. Goodwill and Intangible Assets

The table below reconciles the change in the carrying amount of goodwill by operating segment for the period from March 31, 2008 to June 30, 2008.

	C4I	RSTA	Sustainment Systems (in thousands)	Technical Services	Total
Balance as of March 31, 2008	\$ 661,531	\$ 180,114	\$ 1,051,075	\$ 731,869	\$ 2,624,589
Settlement of 2002-2004 IRS audits	(2,549)	71			(2,478)
Foreign currency translation adjustment	239		71		310
Balance as of June 30, 2008	\$ 659,221	\$ 180,185	\$ 1,051,146	\$ 731,869	\$ 2,622,421

The following disclosure presents certain information regarding the Company's acquired intangible assets as of June 30, 2008 and March 31, 2008. All acquired intangible assets are being amortized over their estimated useful lives, as indicated below, with no estimated residual values.

Acquired Intangible Assets	Weighted Average Amortization Period	Gross Carrying Amount	Accumulated Amortization (in thousands)	Net Balance
<b>As of June 30, 2008</b>				
Technology-based intangibles	18 years	\$ 47,879	\$ (20,675)	\$ 27,204
Customer and program/contract-related intangibles	11 years	214,544	(81,290)	133,254
Total		\$ 262,423	\$ (101,965)	\$ 160,458
<b>As of March 31, 2008</b>				
Technology-based intangibles	18 years	\$ 47,879	\$ (19,945)	\$ 27,934
Customer and program/contract-related intangibles	11 years	214,536	(74,696)	139,840
Total		\$ 262,415	\$ (94,641)	\$ 167,774

The aggregate acquired intangible asset amortization expense for the three-month periods ended June 30, 2008 and 2007 was \$7.3 million. The estimated acquired intangible asset annual amortization expense is expected to be approximately \$29.2 million for fiscal year 2009, \$28.3 million for fiscal year 2010, \$27.5 million for fiscal year 2011, \$14.0 million for fiscal year 2012 and \$13.6 million for fiscal year 2013.



## DRS TECHNOLOGIES, INC. AND SUBSIDIARIES

## Notes to the Consolidated Financial Statements (Continued)

(Unaudited)

## 8. Product Warranties

Product warranty costs generally are accrued when the covered products are delivered to the customer. Product warranty costs are recognized based on the terms of the product warranty and the related estimated costs, considering historical claims experience. Accrued warranty costs are reduced as these costs are incurred and as the warranty period expires, and otherwise may be modified as specific product performance issues are identified and resolved. The table below presents the changes in the Company's accrual for product warranties for the three months ended June 30, 2008 and 2007, which are included in accrued expenses and other current liabilities.

	Three Months Ended June 30,	
	2008	2007
	(in thousands)	
Balance at beginning of period	\$43,613	\$31,180
Accruals for product warranties issued during the period	6,600	6,732
Settlements made during the period	(5,603)	(4,586)
Other	11	187
Balance at end of the period	\$44,621	\$33,513

## 9. Debt

	June 30, 2008	March 31, 2008
	(in thousands)	
Credit Facility:		
Revolving line of credit	\$	\$
Term loan	118,811	119,499
Canadian Term Loan	6,774	7,273
6 <sup>5</sup> / <sub>8</sub> % Senior Notes due 2016	350,000	350,000
7 <sup>5</sup> / <sub>8</sub> % Senior Subordinated Notes due 2018	250,000	250,000
6 <sup>7</sup> / <sub>8</sub> % Senior Subordinated Notes due 2013	550,000	550,000
2.0% Convertible Senior Notes due 2026	345,000	345,000
Unamortized Bond Premium on 6 <sup>7</sup> / <sub>8</sub> % Senior Subordinated Notes	6,040	6,323
Other obligations	5,260	4,757
	1,631,885	1,632,852
Less:		
Short-term borrowings and current installments of long-term debt	350,412	5,384
Total long-term debt	\$1,281,473	\$1,627,468

The weighted average interest rate on the Company's term loan borrowings was 4.3% as of June 30, 2008 (4.4% as of March 31, 2008). At June 30, 2008 and March 31, 2008, there were no outstanding revolving line of credit borrowings against the Credit Facility.

From time to time, the Company enters into standby letters-of-credit and bank guarantee agreements with financial institutions and customers, primarily relating to the guarantee of its future performance on certain contracts to provide products and services and to secure advance payments it has received from its customers. As of June 30, 2008, \$29.0 million was contingently payable under

**DRS TECHNOLOGIES, INC. AND SUBSIDIARIES**

**Notes to the Consolidated Financial Statements (Continued)**

**(Unaudited)**

**9. Debt (Continued)**

letters of credit and bank guarantees. Of this amount, approximately \$0.1 million and \$0.5 million in letters of credit and bank guarantees, respectively, were issued under a previous credit agreement and by a bank agreement for the Company's U.K. subsidiary, respectively, and are not considered when determining the availability under the Company's revolving line of credit. At June 30, 2008, the Company had \$371.6 million of availability under its revolving line of credit.

On March 29, 2006, DRS Technologies Canada Company (DRS Canada) established a five-year senior secured term loan (Canadian Term Loan) for approximately \$9.9 million (C\$11.5 million), maturing on April 1, 2011. The weighted average interest rate on the term loan was 4.75% as of June 30, 2008 (5.25% as of March 31, 2008). The carrying value of the Canadian Term Loan increased \$0.1 million during the three months ended June 30, 2008, as a result of the strengthening of the Canadian dollar, compared with the U.S. dollar during that period.

On or prior to February 1, 2010, the 2.0% Convertible Senior Notes due 2026 (Convertible Notes) may be converted by the holder into cash and, if applicable, shares of the Company's common stock under certain circumstances (Conversion Rights) outlined in the indenture agreement. As of June 30, 2008 one of these Conversion Rights was triggered because the average trading price for the Convertible Notes was less than 103% of the average of the closing sale price of the Company's common stock during the consecutive five trading-day period ended June 30, 2008. Consequently, the Company classified the Convertible Notes as current as of June 30, 2008. In the event of conversion, the Company would satisfy the bond principal payment using available cash on hand and borrowings under the Company's revolving line of credit and would settle the conversion value utilizing shares of the Company's common stock.

Accrued interest expense at June 30, 2008 and March 31, 2008 was \$29.2 million and \$29.8 million, respectively.

Certain of the Company's debt arrangements contain customary representations, warranties and default provisions, as well as restrictions that, among other things, limit the amount of debt that the Company may have outstanding. As of June 30, 2008, the Company was in compliance with all covenants.

**10. Earnings per Share**

Basic earnings per share (EPS) is computed by dividing net earnings by the weighted average number of shares of common stock outstanding during each period. The computation of diluted earnings per share includes the effect of shares from the assumed exercise of dilutive stock options,

## DRS TECHNOLOGIES, INC. AND SUBSIDIARIES

## Notes to the Consolidated Financial Statements (Continued)

(Unaudited)

## 10. Earnings per Share (Continued)

convertible debt (if dilutive), non-vested stock and non-vested stock units using the treasury stock method. The following table presents the components of basic and diluted earnings per share:

	Three Months Ended June 30,	
	2008	2007 (Restated)
	(in thousands, except per-share data)	
Basic EPS computation		
Net earnings	\$ 35,405	\$ 25,204
Weighted average common shares outstanding	40,839	40,381
Basic earnings per share	\$ 0.87	\$ 0.62
Diluted EPS computation		
Net earnings	\$ 35,405	\$ 25,204
Diluted common shares outstanding		
Weighted average common shares outstanding	40,839	40,381
Stock options and non-vested awards	993	872
Convertible debt	913	
Diluted common shares outstanding	42,745	41,253
Diluted earnings per share	\$ 0.83	\$ 0.61

At June 30, 2007, there were 246,969 options to acquire DRS common stock outstanding that are excluded from the above calculation because their inclusion would have had an antidilutive effect on EPS for the three months ended June 30, 2007. There were no antidilutive options at June 30, 2008.

For the three-month period ended June 30, 2008, DRS's 2% Convertible Senior Notes due 2026 increased average diluted shares outstanding by 913,043 because the average stock price was greater than \$59.70 per share for the period. For the three-month period ended June 30, 2007, the 2% Convertible Senior Notes had no impact on diluted EPS because the average stock price during such period was below \$59.70.

## 11. Comprehensive Earnings

The components of comprehensive earnings for the three-month periods ended June 30, 2008 and 2007 consisted of the following:

	Three Months Ended June 30,	
	2008	2007 (Restated)
	(in thousands)	
Net earnings	\$ 35,405	\$ 25,204
Other comprehensive earnings:		
Foreign currency translation adjustments	497	3,535

## Edgar Filing: DRS TECHNOLOGIES INC - Form 10-Q

Minimum pension liability, net of income taxes	(75)	(165)
--	------	-------

Comprehensive earnings	\$ 35,827	\$ 28,574
------------------------	-----------	-----------

## DRS TECHNOLOGIES, INC. AND SUBSIDIARIES

## Notes to the Consolidated Financial Statements (Continued)

(Unaudited)

## 12. Pensions and Other Employee Benefits

The following table summarizes the components of net periodic benefit cost for the Company's pension and postretirement benefit plans for the three-month periods ended June 30, 2008 and 2007. These plans are more fully described in Note 13 to the Company's Consolidated Financial Statements for the year ended March 31, 2008.

	Funded Pension Plans		Postretirement Benefit Plans		Unfunded Supplemental Retirement Plans	
	Three Months Ended June 30,					
	2008	2007	2008	2007	2008	2007
	(in thousands)					
Service cost	\$ 897	\$ 1,728	\$ 92	\$ 120	\$ 288	\$ 146
Interest cost	3,737	3,653	334	332	363	361
Expected return on plan assets	(4,554)	(4,065)	(71)	(62)		
Amortization of unrecognized (gain) loss	(40)	102	(54)	(35)	(26)	41
Amortization of transition obligation			32	28		
Amortization of unrecognized prior-service cost	23	3	(6)	(6)	194	194
Net periodic benefit cost	\$ 63	\$ 1,421	\$ 327	\$ 377	\$ 819	\$ 742

The Company expects to contribute \$17.0 million and \$1.7 million to its pension and postretirement plans, respectively, during the fiscal year ended March 31, 2009, of which \$7.9 million and \$0.4 million, respectively, were contributed during the three-month period ended June 30, 2008.

On April 1, 2008, the Company adopted the measurement date provisions of Statement of Financial Accounting Standard (SFAS) SFAS No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans" an amendment of FASB Statements No. 87, 88, 106 and 132(R)" (SFAS 158). SFAS 158 will require the Company to measure plan assets and benefit obligations as of March 31 of each year. The Company previously performed this measurement at December 31 of each year. As a result of implementing the measurement date provisions of SFAS No. 158, the Company recorded an additional quarter of pension and postretirement benefit cost as of April 1, 2008, which resulted in a \$1.2 million increase to its pension and postretirement liability.

## 13. Operating Segments

The Company's four principal operating segments, on the basis of products and services offered are: the Command, Control, Communications, Computers and Intelligence (C4I) Segment, the Reconnaissance, Surveillance & Target Acquisition (RSTA) Segment, the Sustainment Systems Segment and the Technical Services Segment. All other operations, primarily our Corporate Headquarters, are grouped in Other.

The C4I Segment is comprised of the following business areas: Command, Control & Communications (C3), which includes naval display systems, ship communications systems, radar systems, technical support, electronic manufacturing and system integration services, secure voice and data communications, air combat training, electronic warfare, ship network systems and unmanned vehicles, and integration of traditional security infrastructures into a comprehensive border security suite for the Department of Homeland Security; Power Systems, which includes naval and industrial power generation, conversion, propulsion, distribution and control systems; Intelligence Technologies, which includes signals intelligence, communications intelligence, data collection, processing and



**DRS TECHNOLOGIES, INC. AND SUBSIDIARIES**

**Notes to the Consolidated Financial Statements (Continued)**

**(Unaudited)**

**13. Operating Segments (Continued)**

dissemination equipment, high-speed digital data and imaging systems, and mission and flight recorders; Tactical Systems, which includes battle management tactical computer systems, peripherals, electronic test and diagnostics, and vehicle electronics.

The RSTA Segment develops and produces electro-optical sighting, targeting and weapon sensor systems, and image intensification (I<sup>2</sup>) night vision, combat identification and laser aimers/illuminator products, and provides electronic manufacturing services.

The Sustainment Systems Segment designs, engineers and manufactures integrated military electronics and other military support equipment, primarily for the DoD, as well as related heat transfer and air handling equipment, and power generation and distribution equipment for domestic commercial and industrial users. The segment provides these systems for military, humanitarian, disaster recovery and emergency responder applications.

The Technical Services Segment provides engineering services, logistics and training services, advanced technology services, security and asset protection systems and services, telecommunication systems, integration and information technology services, power generation and vehicle armor kits. The segment provides these services for military, intelligence, humanitarian, disaster recovery and emergency responder applications.

Other includes the activities of DRS Corporate Headquarters and certain non-operating subsidiaries of the Company.

On October 1, 2007, the ESSIBuy operating unit, an operating unit of the Technical Services Segment, was consolidated into an operating unit of the Sustainment Systems Segment to achieve certain operating synergies. The balance sheet and operating results of ESSIBuy were reclassified for the period from April 1, 2007 through September 30, 2007.

Transactions between segments generally are negotiated and accounted for under terms and conditions that are similar to other government and commercial contracts; however, these intercompany transactions are eliminated in consolidation. The Company evaluates segment-level performance based on revenues and operating income, as presented in the Consolidated Statements of Earnings. Operating

## DRS TECHNOLOGIES, INC. AND SUBSIDIARIES

## Notes to the Consolidated Financial Statements (Continued)

(Unaudited)

## 13. Operating Segments (Continued)

income, as shown, includes amounts allocated from DRS Corporate operations using an allocation methodology prescribed by U.S. government regulations for government contractors.

	C4I	RSTA	Sustainment Systems	Technical Services	Other	Total
(in thousands)						
<b>Three Months Ended June 30, 2008</b>						
Total revenues	\$ 381,680	\$ 264,628	\$ 148,544	\$ 182,221	\$	\$ 977,073
Intersegment revenues	(17,096)	(6,513)	(876)	(722)		(25,207)
External revenues	\$ 364,584	\$ 258,115	\$ 147,668	\$ 181,499	\$	\$ 951,866
Operating income (loss)	\$ 36,761	\$ 25,729	\$ 15,719	\$ 9,515	\$ (11,575)	\$ 76,149
Total assets	\$1,343,111	\$516,628	\$1,318,086	\$963,299	\$171,778	\$4,312,902
Depreciation and amortization	\$ 6,361	\$ 3,470	\$ 4,777	\$ 3,876	\$ 1,246	\$ 19,730
Capital expenditures	\$ 9,816	\$ 3,494	\$ 2,443	\$ 3,405	\$ 533	\$ 19,691
<b>Three Months Ended June 30, 2007 (Restated)</b>						
Total revenues	\$ 303,221	\$ 154,791	\$ 116,030	\$ 172,804	\$	\$ 746,846
Intersegment revenues	(4,829)	(1,207)	(4,001)	(1,179)		(11,216)
External revenues	\$ 298,392	\$ 153,584	\$ 112,029	\$ 171,625	\$	\$ 735,630
Operating income (loss)	\$ 31,905	\$ 15,718	\$ 10,573	\$ 10,142	\$ (160)	\$ 68,178
Total assets	\$1,237,376	\$414,148	\$1,349,330	\$946,081	\$172,236	\$4,119,171
Depreciation and amortization	\$ 5,932	\$ 3,368	\$ 4,407	\$ 3,459	\$ 1,347	\$ 18,513
Capital expenditures	\$ 7,887	\$ 1,589	\$ 1,371	\$ 696	\$ 2,350	\$ 13,893

The operating loss for "Other" for the three-month period ended June 30, 2008 was primarily due to the \$11.5 million in investment banking, legal and consulting related expenses relating to the pending merger with Finmeccanica.

## DRS TECHNOLOGIES, INC. AND SUBSIDIARIES

## Notes to the Consolidated Financial Statements (Continued)

(Unaudited)

**14. Supplemental Cash Flow Information**

	Three Months Ended June 30,	
	2008	2007
Cash paid for:		
Interest	\$ 22,800	\$ 24,298
Income taxes	\$ 26,544	\$ 14,432
Supplemental disclosure of significant non-cash investing activities:		
Acquisition earn-out Codem Systems, Inc.	\$	\$ 2,638
Acquisition earn-out WalkAbout Computer Systems, Inc.	\$	\$ 35
Contribution of fixed assets to joint venture	\$	\$ 429
Fixed assets vouchered but not paid	\$ 2,372	\$ 198

**15. Cash Dividends on DRS Common Stock**

On May 12, 2008, the Board of Directors declared a \$0.03 per common share cash dividend, payable on June 30, 2008 to stockholders of record as of June 13, 2008. Cash dividends paid for the three-month period ended June 30, 2008 were \$1.2 million. On August 7, 2008, the Board of Directors declared a \$0.03 per common share cash dividend, payable on September 30, 2008 to stockholders of record as of September 15, 2008.

**16. Contingencies**

Various legal actions, claims, assessments and other contingencies, including certain matters described below, are pending against the Company and certain of the Company's subsidiaries. These matters are subject to many uncertainties, and it is possible that some of these matters ultimately could be decided, resolved or settled adversely. The Company has recorded accruals totaling \$3.0 million at June 30, 2008 and March 31, 2008 for losses related to those matters that the Company considers to be probable and that can be reasonably estimated (certain legal and environmental matters are discussed in detail below). Although, at June 30, 2008, the precise amount of liability that may result from those matters for which the Company has recorded accruals is not ascertainable, the Company believes that any amounts exceeding the Company's recorded accruals should not materially affect the Company's financial condition or liquidity. It is possible, however, that the ultimate resolution of those matters could result in a material adverse effect on the Company's results of operations and/or cash flows from operating activities for a particular reporting period.

Some environmental laws, such as the Comprehensive Environmental Response, Compensation and Liability Act of 1980 (also known as CERCLA or the Superfund law) and similar state statutes, can impose liability upon former owners or operators for the entire cost of investigating and remediating contaminated sites regardless of the lawfulness of the original activities that led to the contamination. In July 2000, prior to its acquisition by Integrated Defense Technologies, Inc., Tech-Sym Corporation, an indirect subsidiary of the Company, received a Section 104(e) Request for Information from the National Park Service (NPS), pursuant to CERCLA, regarding a site known as the Orphan Mine site in the Grand Canyon National Park, Arizona. The Orphan Mine, which was operated by an alleged predecessor to Tech Sym between 1956 and 1967, is the subject of an NPS investigation

DRS TECHNOLOGIES, INC. AND SUBSIDIARIES

Notes to the Consolidated Financial Statements (Continued)

(Unaudited)

16. Contingencies (Continued)

regarding the presence of residual radioactive materials and contamination. Following Tech-Sym's response to the Request for Information, the NPS directed Tech Sym and another alleged former owner/operator to perform an Engineering Evaluation and Cost Analysis (EE/CA) of the site. Tech Sym made a good faith offer to conduct the EE/CA, but the NPS rejected this offer and may perform the EE/CA itself, or negotiate directly with another potentially responsible party for the performance of the EE/CA. Following completion of the EE/CA, the NPS may direct one or more of the potentially responsible parties to perform any remediation that may be required by CERCLA. The Company believes that it has legitimate defenses to Tech-Sym's potential liability and that there are other potentially responsible parties for the environmental conditions at the site, including the U.S. government as owner, operator and arranger at the site. The potential liability associated with this matter can change substantially, due to such factors as additional information on the nature or extent of contamination, methods of remediation that might be recommended or required, changes in the apportionment of costs among the responsible parties and other actions by governmental agencies or private parties.

In connection with the Company's acquisition of ESSI in January 2006, the Company has been made aware of certain legal actions, claims, assessments and other contingencies, including those described below.

In December 2004, ESSI was notified by the Enforcement Division of the SEC of the issuance of a formal order directing a private investigation and was notified that the SEC had issued subpoenas to various individuals associated with ESSI to produce certain documents. The SEC staff also requested that ESSI produce certain documents in connection with the investigation. The subpoenas related to trading in ESSI stock around ESSI's earnings releases in 2003 and to the adequacy of certain disclosures made by ESSI regarding related-party transactions in 2002 and 2003 involving insurance policies placed by ESSI through an insurance brokerage firm in which an ESSI director was a principal at the time of the transactions. In February 2007, the SEC filed a civil injunctive action in the United States District Court for the Eastern District of Missouri, Eastern Division, against a former director, officer and consultant of ESSI, alleging that he had violated the federal securities laws by "tipping" his financial advisor and close friend by sharing material, nonpublic information regarding ESSI's financial condition shortly before certain 2003 earnings announcements. That action is scheduled for trial on December 15, 2008.

On or about September 23, 2005, the SEC staff advised ESSI's counsel that it had issued a subpoena directed to ESSI and expanded its investigation to include ESSI's disclosure of a November 2004 stop work order relating to ESSI's Deployable Power Generation and Distribution Systems (DPGDS) program for the U.S. Air Force and relating to trading in ESSI stock by certain individuals associated with ESSI. In connection with the foregoing SEC investigation, ESSI and certain of its directors and officers have provided information and/or testimony to the SEC. ESSI has received no additional subpoenas or requests for information from the SEC on these subject matters since May 2006.

In January 2006, ESSI was informed that the Office of the U.S. Attorney for the Eastern District of Missouri was initiating an investigation into ESSI's disclosure of the DPGDS stop-work order and into trading in ESSI stock by ESSI insiders, which preceded such disclosure. The U.S. Attorney's office advised ESSI that although it considered ESSI to be a subject of its investigation, ESSI was not a

**DRS TECHNOLOGIES, INC. AND SUBSIDIARIES**

**Notes to the Consolidated Financial Statements (Continued)**

**(Unaudited)**

**16. Contingencies (Continued)**

target. In connection with this investigation, the U.S. Attorney's office issued ESSI a subpoena requesting specified information, which ESSI has furnished. ESSI has received no additional subpoenas or requests for information from the U.S. Attorney's office on these subject matters since May 2006.

In May 2006, the Company was advised that the Enforcement Division of the SEC and the U.S. Attorney's office each had expanded its investigation to include possible "backdating" of the timing of option grants at ESSI prior to the time ESSI was acquired by the Company. As a part of its investigation, the SEC issued subpoenas to certain former officers and employees of ESSI to provide testimony and produce certain documents.

In February 2007, the SEC filed civil injunctive actions in the United States District Court for the Eastern District of Missouri, Eastern Division, alleging that ESSI's former Chief Financial Officer and former Controller had each participated in a backdating scheme. Also in February 2007, the SEC reported that ESSI's former Controller had settled its action against him by consenting to disgorgement, financial penalties, an officer and director bar and a permanent suspension from practicing before the SEC as an accountant. In July 2007, the SEC filed civil injunctive actions in the United States District Court for the Eastern District of Missouri, Eastern Division, alleging that ESSI's former Chairman of the Board and Chief Executive Officer and his son (who was also a member of ESSI's Board of Directors and Compensation Committee) each participated in a backdating scheme. The pending SEC actions have been consolidated and stayed at the request of the U.S. Attorney's office pending resolution of related criminal proceedings.

In March 2007, ESSI's former Controller pleaded guilty to a one-count information brought by the office of the United States Attorney for the Eastern District of Missouri, charging him with making false statements to the government. In connection with his plea, this former ESSI executive admitted that a number of documents filed by ESSI with the SEC contained the materially false statement that the option price of shares subject to the ESSI stock option plan was the closing price of the stock on the date the options were awarded.

In March 2007, ESSI's former Chief Financial Officer was indicted by the grand jury of the United States District Court for the Eastern District of Missouri relating to the backdating of the timing of stock options at ESSI prior to the time ESSI was acquired by DRS. In July 2007, ESSI's former Chairman of the Board and Chief Executive Officer and his son (who was also a member of ESSI's Board of Directors and Compensation Committee) were each indicted on similar charges. The July 2007 superseding indictment charges these former ESSI officers and directors with twelve counts of fraud based on allegations that they backdated stock options on at least eight occasions between 1996 and 2002.

In July 2008, ESSI's former Chairman of the Board and Chief Executive Officer and former Chief Financial Officer each pleaded guilty to falsifying (or causing the falsification of) the records of a publicly traded company. In connection with their respective pleas, ESSI's former Chairman of the Board and Chief Executive Officer admitted that he knowingly and intentionally signed falsely dated stock option award letters, and ESSI's former Chief Financial Officer admitted that he caused such falsely dated award letters to be issued to stock option recipients. Under their respective plea agreements, criminal penalties are to be determined in accordance with the federal sentencing guidelines (which provide for a presumptive incarceration range of 15 to 21 months) but may be

**DRS TECHNOLOGIES, INC. AND SUBSIDIARIES**

**Notes to the Consolidated Financial Statements (Continued)**

**(Unaudited)**

**16. Contingencies (Continued)**

adjusted downward by the sentencing judge. ESSI's former Chairman of the Board and Chief Executive Officer and former Chief Financial Officer also agreed to make restitution payments of approximately \$7.9 million and \$1.8 million, respectively. The remaining charges against these former executives and the indictment issued against ESSI's former Chairman of the Board and Chief Executive Officer's son (who was also a member of ESSI's Board of Directors and Compensation Committee) were dismissed.

Although ESSI continues to be a subject of the U.S. Attorney's office's investigation, the U.S. Attorney's office has advised the Company that ESSI is not a target. Because the events being investigated occurred prior to the time of the Company's acquisition of ESSI, the U.S. Attorney's office has further advised the Company that it considers DRS to be a witness, not a subject or target of its investigation.

The Company is committed to full cooperation with regard to the foregoing investigations and proceedings. The Company is unable to determine at this time the impact, if any, these matters could have on the Company.

In September 2006, the Internal Revenue Service commenced an audit of ESSI's Federal tax returns for the tax periods ended October 31, 2004, October 31, 2005 and January 31, 2006. Thereafter, the Internal Revenue Service agreed, subject to Congressional approval, to close these audits based on ESSI's agreement to accept certain proposed adjustments (primarily involving the reversal of certain compensation deductions taken during these tax years) and a corresponding assessment of approximately \$11.3 million (exclusive of interest), which previously was accrued. In September 2007, the Company received written confirmation from the Congressional Joint Committee on Taxation that it took no exception to the proposed adjustments.

In August 2007, a shareholder derivative complaint was filed in the United States District Court for the Eastern District of Missouri against ESSI's former Chairman of the Board and Chief Executive Officer, his son (who was also a member of ESSI's Board of Directors and Compensation Committee), ESSI's former Chief Financial Officer and ESSI's former Controller relating to the alleged backdating of stock options prior to ESSI's acquisition by DRS. The complaint also contains claims against the Company as a nominal defendant and against each of the current members of the Company's Board of Directors relating to the alleged backdating of ESSI stock options and the ESSI acquisition. The Company believes the claims made against the Company and its current Directors are without merit. The U.S. Attorney's office has moved to intervene and stay the case pending resolution of the related criminal charges against the individual ESSI defendants. DRS and the DRS Directors have moved to dismiss the case on substantive and jurisdictional grounds. Those motions are pending.

In January 2008, the Company received an inquiry from the Australian Competition and Consumer Commission (ACCC) related to one of its subsidiaries, DRS Training & Control Systems, Inc. The ACCC has requested documents and information regarding allegations of possible anticompetitive activity in violation of the Australian Trade Practices Act. In April 2008, the Company provided the documents and information requested by the ACCC. The Company has commenced an internal investigation involving this matter, but is currently unable to determine the timing or the impact, if any, that the matter may have on the Company.

In May 2008, the Company was notified that the NYSE Regulation Inc.'s Market Trading Analysis Department (the NYSE) and the SEC had each commenced independent inquiries regarding trading in

**DRS TECHNOLOGIES, INC. AND SUBSIDIARIES**

**Notes to the Consolidated Financial Statements (Continued)**

**(Unaudited)**

**16. Contingencies (Continued)**

DRS securities prior to the public announcement that Finmeccanica and the Company had entered into a definitive merger agreement pursuant to which Finmeccanica had agreed to acquire the Company for \$81.00 per share subject to the terms thereof. In each case, the Company was asked to provide certain documents and information. The Company was advised by the SEC that its informal inquiry should not be construed as an indication by the SEC or its staff that any violations of law have occurred or as an adverse reflection upon any person or security. Similarly, the NYSE advised the Company that it was engaged in a fact gathering process and that no inference of impropriety should be inferred.

In May 2008, a plaintiff filed a putative class action lawsuit against the Company and the members of its board of directors in the Superior Court of the State of New Jersey, challenging the transactions contemplated by the merger agreement and alleging breaches of fiduciary duty. In June 2008, the defendants filed a motion to dismiss the complaint in its entirety, a motion for a protective order to stay discovery, and a motion to transfer the action from the Law Division to the Chancery Division, General Equity. On July 11, 2008, the plaintiff filed a motion for leave to amend his complaint. The Court granted this motion on July 16, 2008, transferred the action from the Law Division to the Chancery Division, General Equity, and stayed certain matters in the case. The amended complaint asserts a claim for breach of fiduciary duties against the director defendants and a claim for aiding and abetting breach of fiduciary duties against the Company and its general counsel. The amended complaint alleges, among other things, that the proposed transaction arises out of a flawed process. The plaintiff also alleges that the Company's preliminary proxy statement, filed with the SEC on June 13, 2008, contained misleading disclosures and/or omits certain material information. The plaintiff seeks, among other things, an order enjoining the defendants from consummating the transaction and directing the individual defendants to exercise their fiduciary duties to obtain a transaction that is in the best interests of the Company's shareholders. On July 25, 2008, the defendants moved to dismiss the amended complaint in its entirety for failure to state a claim. The Company believes that the claims asserted by the plaintiff in the amended complaint are wholly without merit and intends to defend vigorously against the action.

**17. Related-Party Transactions**

The Company currently leases a building in Oakland, New Jersey owned by LDR Realty Co., a partnership that was wholly owned, in equal amounts, by David E. Gross, DRS's co-founder and former President and Chief Technical Officer, and the late Leonard Newman, DRS's co-founder and former Chairman of the Board, Chief Executive Officer and Secretary and the father of Mark S. Newman, DRS's current Chairman of the Board, President and Chief Executive Officer. Following Leonard Newman's death in November 1998, Mrs. Ruth Newman, the wife of Leonard Newman and the mother of Mark S. Newman, succeeded to Leonard Newman's interest in LDR Realty Co. The lease agreement, with a monthly rental of \$21.2 thousand, expired on April 30, 2007. The new lease commenced May 1, 2007 with the new monthly rental commencing on June 1, 2007 of \$21.8 thousand for the first year with annual increases of approximately 3% every June 1. The lease expires August 31, 2010.

Skadden, Arps, Slate, Meagher & Flom LLP, a law firm to which a member of the Company's Board is of counsel, provided legal services to the Company during the three months ended June 30,

**DRS TECHNOLOGIES, INC. AND SUBSIDIARIES**

**Notes to the Consolidated Financial Statements (Continued)**

**(Unaudited)**

**17. Related-Party Transactions (Continued)**

2008 and 2007. Fees paid to Skadden, Arps, Slate, Meagher & Flom LLP for the three months ended June 30, 2008 and 2007 were \$0.8 million and \$0.9 million, respectively.

In the fourth quarter of fiscal 2007, the stepson of Mark S. Newman, the Company's Chairman of the Board, President and Chief Executive Officer, commenced employment with Nemco Brokerage, Inc., a firm that has a longstanding relationship of providing insurance brokerage services to the Company and which receives commissions from third-party insurers based on policies it places on the Company's behalf.

**18. Guarantor and Non-Guarantor Financial Statements**

As presented in Note 9, "Debt," the Company has \$350.0 million 6<sup>5</sup>/<sub>8</sub>% Senior Notes, \$550.0 million 6<sup>7</sup>/<sub>8</sub>% Senior Subordinated Notes, \$250.0 million 7<sup>5</sup>/<sub>8</sub>% Senior Subordinated Notes and \$345.0 million 2% Convertible Senior Notes outstanding (collectively, the Notes). The Notes are fully and unconditionally guaranteed, jointly and severally, by the Company's wholly-owned domestic subsidiaries (the Guarantor Subsidiaries). The foreign subsidiaries and certain domestic subsidiaries of DRS (the Non-Guarantor Subsidiaries) do not guarantee the Notes.

The following condensed consolidating financial information in the Condensed Consolidating Balance Sheets as of June 30, 2008 and March 31, 2008, the Condensed Consolidating Statements of Earnings for the three-month periods ended June 30, 2008 and 2007, and the Condensed Consolidating Statements of Cash Flows for the three-month periods ended June 30, 2008 and 2007 presents:

- a) DRS Technologies, Inc. (the Parent),
- b) the Guarantor Subsidiaries,
- c) the Non-Guarantor Subsidiaries, and
- d) DRS Technologies, Inc. on a consolidated basis.

The information includes elimination entries necessary to consolidate the Parent with the Guarantor and Non-Guarantor Subsidiaries.

The Guarantor and Non-Guarantor subsidiaries are presented on a combined basis. The principal elimination entries eliminate investments in subsidiaries and intercompany balances and transactions. Separate financial information for each of the Guarantor and Non-Guarantor Subsidiaries is not presented because management believes such financial statements would not be meaningful to investors.



## DRS TECHNOLOGIES, INC. AND SUBSIDIARIES

## Notes to the Consolidated Financial Statements (Continued)

(Unaudited)

## 18. Guarantor and Non-Guarantor Financial Statements (Continued)

**Condensed Consolidating Balance Sheet**  
**As of June 30, 2008**  
(in thousands)

	Parent Company	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated
<b>Assets</b>					
<b>Current assets</b>					
Cash and cash equivalents	\$ 60,848	\$	\$ 25,004	\$ (25,993)	\$ 59,859
Accounts receivable, net	5	525,536	22,349		547,890
Inventories, net		419,473	66,610	(321)	485,762
Prepaid expenses, deferred income taxes and other current assets	189,429	244,516	49,226	(350,493)	132,678
Intercompany receivables	2,142,453			(2,142,453)	
<b>Total current assets</b>	2,392,735	1,189,525	163,189	(2,519,260)	1,226,189
Property, plant and equipment, net	15,324	227,899	16,656		259,879
Acquired intangibles, net		160,069	389		160,458
Goodwill	24,116	2,551,427	46,878		2,622,421
Deferred income taxes and other noncurrent assets	14,592	44,986	17,317	(32,940)	43,955
Investment in subsidiaries	1,143,419	36,898	7	(1,180,324)	
<b>Total assets</b>	\$3,590,186	\$4,210,804	\$244,436	\$(3,732,524)	\$4,312,902
<b>Liabilities and Stockholders' Equity</b>					
<b>Current liabilities</b>					
Short-term borrowings and current installments of long-term debt	\$ 347,750	\$ 210	\$ 2,452	\$	\$ 350,412
Accounts payable	5,034	274,236	33,058		312,328
Accrued expenses and other current liabilities	213,390	595,110	59,001	(350,900)	516,601
Intercompany payables		712,673	13,064	(725,737)	
<b>Total current liabilities</b>	566,174	1,582,229	107,575	(1,076,637)	1,179,341
Long-term debt, excluding current installments	1,272,100	3,553	5,820		1,281,473
Other liabilities	27,725	111,352	21,764	(32,940)	127,901
<b>Total liabilities</b>	1,865,999	1,697,134	135,159	(1,109,577)	2,588,715
<b>Total stockholders' equity</b>	1,724,187	2,513,670	109,277	(2,622,947)	1,724,187
	\$3,590,186	\$4,210,804	\$244,436	\$(3,732,524)	\$4,312,902

**Total liabilities and  
stockholders' equity**

24

---

## DRS TECHNOLOGIES, INC. AND SUBSIDIARIES

## Notes to the Consolidated Financial Statements (Continued)

(Unaudited)

## 18. Guarantor and Non-Guarantor Financial Statements (Continued)

**Condensed Consolidating Balance Sheet**  
**As of March 31, 2008**  
(in thousands)

	Parent Company	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated
<b>Assets</b>					
<b>Current assets</b>					
Cash and cash equivalents	\$ 65,130	\$	\$ 31,195	\$ (10,074)	\$ 86,251
Accounts receivable, net	4	549,463	24,662		574,129
Inventories, net		390,594	46,610	505	437,709
Prepaid expenses, deferred income taxes and other current assets	191,400	242,233	45,639	(351,806)	127,466
Intercompany receivables	2,105,884		4,834	(2,110,718)	
<b>Total current assets</b>	2,362,418	1,182,290	152,940	(2,472,093)	1,225,555
Property, plant and equipment, net	16,096	224,589	14,992		255,677
Acquired intangibles, net		167,301	473		167,774
Goodwill	24,116	2,553,906	46,567		2,624,589
Deferred income taxes and other noncurrent assets	16,591	41,985	16,805	(32,941)	42,440
Investment in subsidiaries	1,143,419	36,861	44	(1,180,324)	
<b>Total assets</b>	\$ 3,562,640	\$ 4,206,932	\$ 231,821	\$ (3,685,358)	\$ 4,316,035
<b>Liabilities and Stockholders' Equity</b>					
<b>Current liabilities</b>					
Current installments of long-term debt	\$ 2,750	\$ 225	\$ 2,409	\$	\$ 5,384
Accounts payable	11,824	312,892	33,143		357,859
Accrued expenses and other current liabilities	219,793	578,701	60,862	(351,806)	507,550
Intercompany payables		721,477		(721,477)	
<b>Total current liabilities</b>	234,367	1,613,295	96,414	(1,073,283)	870,793
Long-term debt, excluding current installments	1,618,071	3,017	6,380		1,627,468
Other liabilities	26,596	116,592	23,921	(32,941)	134,168
<b>Total liabilities</b>	1,879,034	1,732,904	126,715	(1,106,224)	2,632,429
<b>Total stockholders' equity</b>	1,683,606	2,474,028	105,106	(2,579,134)	1,683,606
<b>Total liabilities and stockholders' equity</b>	\$ 3,562,640	\$ 4,206,932	\$ 231,821	\$ (3,685,358)	\$ 4,316,035



## DRS TECHNOLOGIES, INC. AND SUBSIDIARIES

## Notes to the Consolidated Financial Statements (Continued)

(Unaudited)

## 18. Guarantor and Non-Guarantor Financial Statements (Continued)

**Condensed Consolidating Statements of Earnings**  
**Three Months Ended June 30, 2008**  
(in thousands)

	Parent Company	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated
<b>Revenues</b>	\$	\$ 888,112	\$ 73,097	\$ (9,343)	\$ 951,866
Cost and expenses	11,551	806,389	66,293	(8,516)	875,717
Operating income	(11,551)	81,723	6,804	(827)	76,149
Interest income	175	35	90		300
Interest and related expense	23,211	145	115		23,471
Other (income) expense, net	(70)	375	(65)		240
Management fees	891	(843)	(48)		
Royalties	566		(566)		
Intercompany interest	21,429	(21,236)	(193)		
Earnings (losses) before noncontrolling interest and income taxes	(11,631)	59,159	6,037	(827)	52,738
Noncontrolling interest			414		414
Earnings (losses) before income taxes	(11,631)	59,159	5,623	(827)	52,324
Income taxes	(3,201)	19,129	1,818	(827)	16,919
Earnings (losses) from subsidiary entities	43,835			(43,835)	
<b>Net earnings</b>	\$ 35,405	\$ 40,030	\$ 3,805	\$ (43,835)	\$ 35,405

## DRS TECHNOLOGIES, INC. AND SUBSIDIARIES

## Notes to the Consolidated Financial Statements (Continued)

(Unaudited)

## 18. Guarantor and Non-Guarantor Financial Statements (Continued)

**Condensed Consolidating Statements of Earnings**  
**Three Months Ended June 30, 2007**  
(in thousands)  
(Restated)

	Parent Company	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated
<b>Revenues</b>	\$	\$ 674,503	\$ 64,238	\$ (3,111)	\$ 735,630
Cost and expenses	142	611,923	58,494	(3,107)	667,452
Operating income	(142)	62,580	5,744	(4)	68,178
Interest income	501	(8)	66		559
Interest and related expense	28,483	85	142		28,710
Other (income) expense, net	(577)	(61)	708		70
Management fees	781	(744)	(37)		
Royalties	412		(412)		
Intercompany interest	23,376	(23,363)	(13)		
Earnings (losses) before noncontrolling interest and income taxes	(2,978)	38,441	4,498	(4)	39,957
Noncontrolling interest			493		493
Earnings (losses) before income taxes	(2,978)	38,441	4,005	(4)	39,464
Income taxes	(1,075)	13,897	1,442	(4)	14,260
Earnings (losses) from subsidiary entities	27,107			(27,107)	
<b>Net earnings</b>	\$ 25,204	\$ 24,544	\$ 2,563	\$ (27,107)	\$ 25,204

## DRS TECHNOLOGIES, INC. AND SUBSIDIARIES

## Notes to the Consolidated Financial Statements (Continued)

(Unaudited)

## 18. Guarantor and Non-Guarantor Financial Statements (Continued)

**Condensed Consolidating Statements of Cash Flows**  
**Three Months Ended June 30, 2008**  
(in thousands)

	Parent Company	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated
<b>Net cash provided by (used in) operating activities</b>	\$ 22,241	\$ (9,620)	\$ (20,496)	\$	\$ (7,875)
<b>Cash flows from investing activities</b>					
Capital expenditures	(474)	(16,803)	(2,414)		(19,691)
Dispositions of property, plant & equipment	1	(1)	1		1
<b>Net cash used in investing activities</b>	(473)	(16,804)	(2,413)		(19,690)
<b>Cash flows from financing activities</b>					
Borrowings on revolving line of credit	115,000				115,000
Repayments of revolving line of credit	(115,000)				(115,000)
Borrowings of short-term debt		118			118
Borrowings of long-term debt		580			580
Repayments of long-term debt	(688)	(59)	(602)		(1,349)
Excess tax benefit realized from share-based payment arrangements	706				706
Proceeds from stock option exercises	2,013				2,013
Dividends paid	(1,225)				(1,225)
Other		200			200
Net (repayments to) borrowings from parent company	(26,856)	25,585	17,190	(15,919)	
<b>Net cash (used in) provided by financing activities</b>	(26,050)	26,424	16,588	(15,919)	1,043
<b>Effect of exchange rates on cash and cash equivalents</b>			130		130
<b>Net decrease in cash and cash equivalents</b>	(4,282)		(6,191)	(15,919)	(26,392)
<b>Cash and cash equivalents, beginning of period</b>	65,130		31,195	(10,074)	86,251
<b>Cash and cash equivalents, end of period</b>	\$ 60,848	\$	\$ 25,004	\$ (25,993)	\$ 59,859

## DRS TECHNOLOGIES, INC. AND SUBSIDIARIES

## Notes to the Consolidated Financial Statements (Continued)

(Unaudited)

## 18. Guarantor and Non-Guarantor Financial Statements (Continued)

**Condensed Consolidating Statements of Cash Flows**  
**Three Months Ended June 30, 2007**  
(in thousands)

	Parent Company	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated
<b>Net cash (used in) provided by operating activities</b>	\$ (40,272)	\$ 46,450	\$ (5,651)	\$	\$ 527
<b>Cash flows from investing activities</b>					
Capital expenditures	(2,841)	(9,483)	(1,569)		(13,893)
Other, net		4			4
<b>Net cash used in investing activities</b>	(2,841)	(9,479)	(1,569)		(13,889)
<b>Cash flows from financing activities</b>					
Borrowings on revolving line of credit	90,000				90,000
Repayments of revolving line of credit	(90,000)				(90,000)
Repayments of long-term debt	(50,688)	(49)	(580)		(51,317)
Excess tax benefit realized from share-based payment arrangements	1,413				1,413
Proceeds from stock option exercises	2,664				2,664
Dividends paid	(1,213)				(1,213)
Other			3		3
Net borrowings from (repayments to) parent company	30,138	(36,922)	8,224	(1,440)	
<b>Net cash (used in) provided by financing activities</b>	(17,686)	(36,971)	7,647	(1,440)	(48,450)
<b>Effects of exchange rates on cash and cash equivalents</b>			92		92
<b>Net (decrease) increase in cash and cash equivalents</b>	(60,799)		519	(1,440)	(61,720)
<b>Cash and cash equivalents, beginning of period</b>	92,795		14,598	(11,560)	95,833
<b>Cash and cash equivalents, end of period</b>	\$ 31,996	\$	\$ 15,117	\$ (13,000)	\$ 34,113

## 19. Recently Issued Accounting Pronouncements

In September 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 157, "Fair Value Measurements" (SFAS 157), which defines fair value, establishes a framework for measuring fair value and expands disclosure requirements about fair value measurements. SFAS 157 was effective beginning April 1, 2008, except for nonfinancial assets and liabilities measured at fair value on a non-recurring basis for which it will be effective April 1, 2009 for the Company. The Company's cash equivalents of \$50.1 million and \$35.6 million at June 30, 2008 and March 31, 2008, respectively, were measured using quoted prices in active



markets for identical items and are valued using published market prices. The impact of the

DRS TECHNOLOGIES, INC. AND SUBSIDIARIES

Notes to the Consolidated Financial Statements (Continued)

(Unaudited)

**19. Recently Issued Accounting Pronouncements (Continued)**

adoption of SFAS 157 was not material to the Company's condensed consolidated financial statements, and the adoption of the items deferred until fiscal 2010 is not expected to be material.

In December 2007, the FASB issued SFAS No. 141 (revised 2007), Business Combinations (SFAS 141R). SFAS 141R significantly changes the way companies account for business combinations and generally will require more assets acquired and liabilities assumed to be measured at their acquisition-date fair value. Under SFAS 141R, legal fees and other transaction-related costs are expensed as incurred and are no longer included in goodwill as a cost of acquiring the business. SFAS 141R also requires, among other things, acquirers to estimate the acquisition date fair value of any contingent consideration and to recognize any subsequent changes in the fair value of contingent consideration in earnings. In addition, restructuring costs the acquirer expected, but was not obligated to incur, will be recognized separately from the business acquisition. This statement is effective beginning April 1, 2009 for DRS.

In December 2007, the FASB issued SFAS No. 160, "Noncontrolling Interests in Consolidated Financial Statements," an Amendment of ARB 51 (SFAS 160). SFAS 160 amends ARB 51 to establish accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. The statement requires consolidated net income to be reported at amounts that include the amounts attributable to both the parent and the noncontrolling interest. It also requires disclosure on the face of the consolidated statement of income of the amounts of consolidated net income attributable to the parent and to the noncontrolling interest. In addition, this statement establishes a single method of accounting for changes in a parent's ownership interest in a subsidiary that do not result in deconsolidation and requires that a parent recognize a gain or loss in net income when a subsidiary is deconsolidated. This statement is effective beginning April 1, 2009 for DRS, and the Company currently is evaluating the impact of this statement on its consolidated financial statements.

In March 2008, the FASB issued SFAS No. 161, Disclosures about Derivative Instruments and Hedging Activities (SFAS 161), which amends SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities (SFAS 133). SFAS 161 enhances the disclosures for derivative instruments and related hedging activities to include, among other disclosures, the location and fair value amounts of derivative instruments, hedged items and related gains and losses in the balance sheet and income statement, presented in a tabular format. SFAS 161 is effective for the Company beginning April 1, 2009 and will be applied prospectively. SFAS 161 will not affect the Company's financial position, results of operations and cash flows, but will require enhanced disclosure.

On May 9, 2008, the FASB issued FASB Staff Position (FSP) Accounting Principles Board (APB) Opinion No. 14-1, "Accounting for Convertible Debt Instruments That May Be Settled in Cash upon Conversion (Including Partial Cash Settlement)" (FSP APB 14-1). The FSP will require cash-settled convertible debt to be separated into debt and equity components at issuance and a value to be assigned to each. The value assigned to the debt component will be the estimated fair value, as of the issuance date, of a similar bond without the conversion feature. The difference between the bond cash proceeds and this estimated fair value will be recorded as a debt discount and amortized to interest expense over the life of the bond. FSP APB 14-1 will become effective for the Company April 1, 2009 and will require retrospective application. The Company currently is assessing the impact the adoption of the FSP will have on the Company's future results of operations, which is expected to be material.

**DRS TECHNOLOGIES, INC. AND SUBSIDIARIES**

**Notes to the Consolidated Financial Statements (Continued)**

**(Unaudited)**

**19. Recently Issued Accounting Pronouncements (Continued)**

In June 2008, the FASB issued FASB FSP EITF 03-6-1, "Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities" (FSP EITF 03-6-1). The FSP addresses whether awards granted in share-based payment transactions are participating securities prior to vesting and, therefore, need to be included in the earnings allocation in computing earnings per share using the two-class method under SFAS No. 128, Earnings per Share. The FSP requires unvested share-based payment awards that have non-forfeitable rights to dividend or dividend equivalents to be treated as a separate class of securities in calculating earnings per share. FSP EITF 03-6-1 will be effective beginning April 1, 2009 and will be retrospectively applied to all prior periods presented. The Company currently is evaluating the impact of the adoption of the FSP on earnings per share.

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

We begin Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A) of DRS Technologies, Inc. and its wholly-owned subsidiaries and controlling interests (hereinafter, we, us, our, the Company or DRS) with a note describing the Restatement of Previously Issued Consolidated Financial Statements, followed by recent developments and a company overview. This is followed by a discussion of the critical accounting estimates that we believe are important to understanding the assumptions and judgments incorporated in our reported financial results, which we discuss under "Results of Operations." We then provide an analysis of cash flows and discuss our financial commitments under "Liquidity and Capital Resources." This MD&A should be read in conjunction with the consolidated financial statements and related notes contained herein and in our March 31, 2008 Annual Report on Form 10-K.

### **Forward-Looking Statements**

The following discussion and analysis contains forward-looking statements, within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, that are based on management's beliefs and assumptions, current expectations, estimates and projections. Such statements, including statements relating to the Company's expectations for future financial performance, are not considered historical facts and are considered forward-looking statements under the federal securities laws. These statements may contain words such as "believes," "anticipates," "plans," "expects," "intends," "estimates" or similar expressions. These statements are not guarantees of our future performance and are subject to risks, uncertainties and other important factors that could cause our actual performance or achievements to differ materially from those expressed or implied by these forward-looking statements and include, without limitation: the effect of our acquisition strategy on future operating results, including our ability to effectively integrate acquired companies into our existing operations; the uncertainty of acceptance of new products and successful bidding for new contracts; the effect of technological changes or obsolescence relating to our products and services; and the effects of government regulation or shifts in government policy, as they may relate to our products and services, and other risks or uncertainties detailed in Item 1A, "Risk Factors," included in our March 31, 2008 Annual Report on Form 10-K. Given these uncertainties, you should not rely on forward-looking statements. The Company undertakes no obligations to update any forward-looking statements, whether as a result of new information, future events or otherwise.

### **Restatement of Previously Issued Consolidated Financial Statements**

In February 2008, we received a comment letter from the staff of the U.S. Securities and Exchange Commission (SEC) on our fiscal 2007 Form 10-K (filed on May 30, 2007) and our fiscal 2008 second quarter Form 10-Q (filed on November 9, 2007). In the initial comment letter and in other subsequent written and telephonic communications with the staff of the SEC, information was requested regarding the timing of a \$36.8 million pretax charge that was recorded in our fiscal 2008 first quarter ended June 30, 2007 for the impact of a redesign on our Thermal Weapon Sight II (TWS II) program.

In March 2007, we stopped production on the TWS II line due to intermittent failures. After several weeks of analysis, we identified the root causes of the failures, and in May 2007 we released a redesign that we believed would address them. The charge reflects our revised estimate of the excess of the total estimated costs to fulfill the scope of work of the TWS II contract over the total TWS II contract value. The total estimated costs to complete the contract reflect all direct costs (primarily labor and material), overhead and allowable general and administrative expenses. The most significant component of the charge was a result of the write-off of certain TWS II on-hand component parts that would no longer be utilized in the new TWS II design. The charge also reflects the estimated future cost of the redesign and cost growth that was unrelated to the redesign.

## Edgar Filing: DRS TECHNOLOGIES INC - Form 10-Q

Following discussions with the staff of the SEC and review of the judgments and estimates we made relating to the charge, we concluded that the \$36.8 million charge should have been recorded in our fiscal 2007 fourth quarter ended March 31, 2007.

As a result of foregoing, we have restated our previously filed consolidated financial statements and selected financial data for the year ended March 31, 2007, inclusive of our fourth quarter ended March 31, 2007 and our previously issued quarterly consolidated financial statements for the three month period ended June 30, 2007 in our March 31, 2008 Form 10-K (filed May 30, 2008). All amounts impacted by the restatement that are presented in the MD&A have been restated to reflect the \$36.8 million charge in the appropriate period.

For additional information and a detailed discussion of the restatement, see Note 3, Restatement of Previously Issued Consolidated Financial Statements, to the accompanying consolidated financial statements.

### Recent Developments

On May 12, 2008, Finmeccanica, S.p.A. (Finmeccanica) and DRS announced that they signed a definitive merger agreement under which Finmeccanica will acquire 100% of DRS stock for \$81.00 per share in cash. The merger agreement provides for, among other things, the merger of a subsidiary of Finmeccanica with and into DRS with DRS as the surviving corporation and becoming a wholly-owned subsidiary of Finmeccanica.

The transaction is subject to approval by the stockholders of DRS, the receipt of regulatory approvals and other closing conditions, including review by U.S. antitrust authorities, the Committee on Foreign Investment in the United States (CFIUS) and the Defense Security Service (DSS). The transaction is expected to close in the fourth quarter of 2008. In the three-month period ended June 30, 2008, we incurred \$11.5 million in investment banking, legal and consulting expenses related to our pending merger as described above.

### Company Overview

DRS is a supplier of defense electronic products, systems and military support services. We provide high-technology products, services and support to all branches of the U.S. military, major aerospace and defense prime contractors, government intelligence agencies, certain international military forces and industrial markets.

The Company has four principal operating segments, on the basis of products and services offered: the Command, Control, Communications, Computers and Intelligence (C4I) Segment, the Reconnaissance, Surveillance & Target Acquisition (RSTA) Segment, the Sustainment Systems Segment and the Technical Services Segment. All other operations, primarily our Corporate Headquarters, are grouped in Other.

On October 1, 2007 the ESSIBuy operating unit, an operating unit of the Technical Services Segment, was consolidated into an operating unit of the Sustainment Systems Segment to achieve certain operating synergies. The balance sheet and operating results of ESSIBuy were reclassified for the period from April 1, 2007 through September 30, 2007.

The C4I Segment is comprised of the following business areas: Command, Control & Communications (C3), which includes naval display systems, ship communications systems, radar systems, technical support, electronic manufacturing and system integration services, secure voice and data communications, air combat training, electronic warfare, ship network systems and unmanned vehicles, and integration of traditional security infrastructures into a comprehensive border security suite for the Department of Homeland Security; Power Systems, which includes naval and industrial power generation, conversion, propulsion, distribution and control systems; Intelligence Technologies,

which includes signals intelligence, communications intelligence, data collection, processing and dissemination equipment, high-speed digital data and imaging systems, and mission and flight recorders; Tactical Systems, which includes battle management tactical computer systems, peripherals, electronic test and diagnostics, and vehicle electronics.

The RSTA Segment develops and produces electro-optical sighting, targeting and weapon sensor systems, image intensification (I<sup>2</sup>) night vision, combat identification and laser aimer/illuminator products, and provides electronic manufacturing services.

The Sustainment Systems Segment designs, engineers and manufactures integrated military electronics and other military support equipment, primarily for the U.S. Department of Defense (DoD), as well as related heat transfer and air handling equipment, and power generation and distribution equipment for domestic commercial and industrial users.

The Technical Services Segment provides engineering services, logistics and training services, advanced technology services, asset protection systems and services, telecommunication systems integration and information technology services, power generation and vehicle armor kits for military, intelligence, humanitarian, disaster recovery and emergency responder applications.

### **Critical Accounting Policies**

Our consolidated financial statements and accompanying notes are prepared in accordance with accounting principles generally accepted in the United States of America. Preparing consolidated financial statements requires us to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses, and disclosures of contingent assets and liabilities. These estimates and assumptions are affected by the application of our accounting policies. Our significant accounting policies are described in Note 1 to the Consolidated Financial Statements included in our March 31, 2008 Annual Report on Form 10-K. There were no significant changes in the Company's critical accounting policies during the three months ended June 30, 2008. Critical accounting policies are those that require application of management's most difficult, subjective or complex judgments, often as a result of the need to make estimates about the effects of matters that are inherently uncertain and may change in subsequent periods. Critical accounting policies for us include revenue recognition on contracts and contract estimates, valuation of goodwill and acquired intangible assets, pension plan and postretirement benefit plan obligations, accounting for income taxes, share-based payments and other management estimates.

### **Results of Operations**

Our operating cycle is long term and involves various types of production contracts and varying production delivery schedules. Accordingly, operating results of a particular year, or year-to-year comparisons of recorded revenues and earnings, may not be indicative of future operating results. Members of our senior management team regularly review key performance metrics and the status of operating initiatives within our business. These key performance indicators are primarily revenues, operating income and bookings. We review this information on a monthly basis through operating segment reviews, which include, among other operating issues, discussions related to significant programs, proposed investments in new business opportunities or property, plant and equipment, and integration and cost reduction efforts. The following table presents a summary comparison of the key

performance metrics, other significant financial metrics and significant liquidity metrics monitored by our senior management.

	Three Months Ended June 30,		
	2008	2007 (Restated)	Percent Change
(in thousands, except percentages)			
<b>Key performance metrics</b>			
Revenues:			
Products	\$ 721,196	\$ 536,825	34.3%
Services	\$ 230,670	\$ 198,805	16.0%
<b>Total revenues</b>	<b>\$ 951,866</b>	<b>\$ 735,630</b>	<b>29.4%</b>
Costs and expenses:			
Cost and expenses Products	\$ 650,855	\$ 482,126	35.0%
% of product revenues	90.2%	89.8%	
Cost and expenses Services	\$ 213,315	\$ 185,326	15.1%
% of service revenues	92.5%	93.2%	
Merger-related expenses	\$ 11,547	\$	n/m
<b>Total costs and expenses</b>	<b>\$ 875,717</b>	<b>\$ 667,452</b>	<b>31.2%</b>
<b>Operating income</b>	<b>\$ 76,149</b>	<b>\$ 68,178</b>	<b>11.7%</b>
Operating income percentage	8.0%	9.3%	
Bookings	\$ 1,065,240	\$ 939,528	13.4%
<b>Other significant financial metrics</b>			
Interest and related expenses	\$ 23,471	\$ 28,710	(18.2)%
Income taxes	\$ 16,919	\$ 14,260	18.6%
<b>Significant liquidity metrics(A)</b>			
Free cash flow	\$ (27,566)	\$ (13,366)	(106.2)%
EBITDA	\$ 95,225	\$ 86,128	10.6%

(A) See "Liquidity and Capital Resources" and "Use of Non-GAAP Financial Measures" for additional discussion and information.

n/m not meaningful

### Three-Month Period Ended June 30, 2008, Compared with the Three-Month Period Ended June 30, 2007

#### Revenues

Consolidated revenue increased \$216.2 million, or 29.4%, to \$951.9 million for the three-month period ended June 30, 2008 as compared with the same period in the prior year. The increase in revenue was comprised of an increase of \$184.4 million and \$31.9 million for product and service revenues, respectively.

#### Revenues Products

Revenue from our products (e.g., hardware, components, systems) increased \$184.4 million, or 34.3%, to \$721.2 million for the three-month period ended June 30, 2008, as compared with the corresponding period in the prior year. The increase was primarily driven by greater shipments of driver vision enhancement equipment and components for ground-based vehicles, certain rugged

computer systems, Thermal Weapon Sights II (TWS II) and roof assemblies for the Mine Resistant Ambush Protected Vehicle (MRAP).

Revenues from driver vision enhancement equipment and components increased significantly as a result of elevated priority placed on the program by the customer to assist in increasing combat vehicle drivers' vision capability, survivability and mobility, which resulted in increased funding and accelerated delivery schedules. Rugged computer systems revenue increased due to increased funding and accelerated customer delivery requirements to supply troops in theatre. TWS II shipments increased due to the fact that shipments were delayed in the prior-year period, and MRAP roof assembly production increased as the program commenced in the second half of fiscal 2008.

Partially offsetting overall higher product revenues were lower shipments of mobile power generation and distribution equipment for the U.S. Air Force, as the program was substantially completed during fiscal 2008, as well as decreased shipments of combat display workstations due to lower demand in the current year and lower shipments of portable surveillance and target acquisition radar due to the timing of shipments.

#### **Revenues Services**

Revenue from services increased \$31.9 million, or 16.0%, to \$230.7 million for the three months ended June 30, 2008, as compared with the corresponding prior-year period. The primary drivers of the increase were revenues from satellite-based communication services and demand for equipment and services under the Rapid Response program. The increased revenue from satellite-based communications is a result of the commencement of program operations in the second half of fiscal 2008 to support deployed personnel. Revenues from the Rapid Response program continue to increase as a result of continued operational demand in Iraq and Afghanistan.

Partially offsetting the increase in service revenues were decreased revenues for a defense communication transmission system program as the contract is substantially complete. We expect to recognize additional revenue on this program as a result of a newly awarded contract.

#### **Costs and expenses/Operating income**

The majority of our business is comprised of thousands of individually unique contracts to design and/or produce defense electronics (components and systems) and to provide other sustainment, logistics management and communications services to the military. In general, we do not manufacture large homogenous product lines.

Costs and expenses include contract costs, consisting of direct costs (labor, material, etc), indirect overhead, allowable general and administrative expenses, as defined below, including internal research and development and bid-and-proposal costs (on certain contracts) and non-allocable costs, such as unallowable general and administrative expenses, as defined below, and amortization of intangible assets.

We bifurcate our total general and administrative (G&A) costs into "allowable" and "unallowable" cost pools, as the terms are defined in the U.S. Federal Acquisition Regulations (FAR) procurement regulations. We account for allowable G&A costs allocated to our government contractor operating units that design, develop and produce complex defense electronic components and systems for specifically identified contracts as contract costs because such costs are generally reimbursable indirect contract costs pursuant to the terms of the contracts. We expense such allowable G&A costs as a component of costs and expenses when the revenues related to those contracts are recognized. Our government contractor operating units allocate allowable G&A costs to their contracts using an indirect overhead rate which is generally based upon allowable G&A costs as a percentage of a total cost (direct labor, manufacturing overhead, raw materials and other direct costs) input base.



## Edgar Filing: DRS TECHNOLOGIES INC - Form 10-Q

Consolidated costs and expenses increased \$208.3 million, or 31.2%, to \$875.7 million for the three-month period ended June 30, 2008, as compared with the corresponding period in the prior year. The increased costs are attributed to a \$168.7 million increase in product-related expenses and a \$28.0 million increase in service-related expenses.

### **Costs and expenses Products**

Product costs and expenses increased \$168.7 million, or 35.0%, for the three-month period ended June 30, 2008, as compared with the corresponding period in the prior year, while increasing 40 basis points as a percentage of product revenues over the same period. The increase in costs and expenses was attributed to significant products revenue growth during the period, as noted above. The increase in cost and expenses as a percentage of product revenues was largely attributable to increased revenues on the TWS II program on which current year deliveries are being recognized at or near break-even due to the unfavorable impact of prior-period design changes, as well as cost growth on certain signal intelligence software programs.

### **Costs and expenses Services**

Costs and expenses services increased \$28.0 million, or 15.1% during the three months ended June 30, 2008, as compared with the corresponding prior-year period, while decreasing 70 basis points as a percentage of service revenues over the same period. The increase in cost and expenses was attributed to service revenue growth during the period, as noted above. The decrease in costs and expenses as a percentage of service revenues was driven by the increase in higher margin depot repairs and engineering services revenue, partially offset by higher general and administrative costs.

**Merger-related expenses** In the three-month period ended June 30, 2008, the Company incurred \$11.5 million in investment banking, legal and consulting expenses related to the pending merger with Finmeccanica.

**Operating income** We consider operating income to be an important measure for evaluating our operating performance and, as is typical in the industry, define operating income as revenues less related costs and expenses of producing the revenues, including allowable general and administrative expenses, and non-allocable costs, as defined above. Operating income is discussed in detail for each of the business segments in which we operate, and the segment operating income is one of the key metrics used by management to internally manage its operations. Consolidated operating income for the three-month period ended June 30, 2008 increased \$8.0 million, or 11.7%, to \$76.1 million, as compared with the corresponding period in the prior year. In addition, operating income as a percentage of revenues decreased 130 basis points, which was attributed to the cost/revenue relationships and merger-related expenses detailed above. See "Operating Segments" discussion for additional information.

**Bookings** We define bookings as the value of contract awards received from the U.S. government for which the U.S. government has appropriated funds, plus the value of contract awards and orders received from customers other than the U.S. government. Bookings for the three-month period ended June 30, 2008 increased \$125.7 million, as compared with the corresponding period in the prior year, to \$1.07 billion. The primary drivers of the increase were strong demand for electro-optical systems for ground vehicles from our RSTA Segment.

**Interest and related expenses** Interest and related expenses decreased \$5.2 million for the three-month period ended June 30, 2008, as compared with corresponding period in the prior year, to \$23.5 million. Lower interest and related expenses were primarily the result of a decrease in our average borrowings outstanding for the three-month period ended June 30, 2008, as compared with the corresponding period in the prior year and a \$1.6 million interest credit related to the completion of federal income tax audits. We had no borrowings outstanding under our revolving credit facility at

## Edgar Filing: DRS TECHNOLOGIES INC - Form 10-Q

June 30, 2008 and June 30, 2007. During fiscal 2008, we prepaid, at our discretion, approximately \$150.0 million of our outstanding term loan, \$100.0 million of which was prepaid during the last nine months of the that fiscal year.

**Income taxes** The provision for income taxes for the three months ended June 30, 2008 reflected an effective income tax rate of approximately 32.3%, as compared with 36.1% in the same period last year. Our effective tax rate decreased primarily due to a favorable settlement with the Internal Revenue Service, (IRS) concerning its examination of our federal income tax returns for the years ended March 31, 2002, 2003 and 2004, which was partially offset by an increase in the effective tax rate due to the scheduled expiration of the research & development credit effective December 31, 2007. We anticipate our effective income tax rate for the year ended March 31, 2009 to approximate 37%.

During the three months ended June 30, 2008, we received notification from the IRS that it had completed its internal administrative review of its audit report and informed us that the audit results had been accepted. As a result of the audit, we made a payment of approximately \$5.5 million, including interest of approximately \$1.3 million, and recognized a discrete tax benefit of approximately \$2.5 million.

### Operating Segments

The following table sets forth, by operating segment, revenues, operating income and operating margin and the percentage increase or decrease of those items, as compared with the prior fiscal year:

	Three Months Ended June 30, 2007 (Restated)		Three Months Ended Percent Changes 2008 vs. 2007
	2008		
(in thousands, except for percentages)			
<b>C4I Segment</b>			
Revenues	\$ 364,584	\$ 298,392	22.2%
Operating income	\$ 36,761	\$ 31,905	15.2%
Operating margin	10.1%	10.7%	(5.6)%
<b>RSTA Segment</b>			
Revenues	\$ 258,115	\$ 153,584	68.1%
Operating income	\$ 25,729	\$ 15,718	63.7%
Operating margin	10.0%	10.2%	(2.0)%
<b>Sustainment Systems Segment</b>			
Revenues	\$ 147,668	\$ 112,029	31.8%
Operating income	\$ 15,719	\$ 10,573	48.7%
Operating margin	10.6%	9.4%	12.8%
<b>Technical Services Segment</b>			
Revenues	\$ 181,499	\$ 171,625	5.8%
Operating income	\$ 9,515	\$ 10,142	(6.2)%
Operating margin	5.2%	5.9%	(11.9)%
<b>Other</b>			
Operating loss	\$ (11,575)	\$ (160)	n/m
n/m not meaningful			

## Edgar Filing: DRS TECHNOLOGIES INC - Form 10-Q

Three-Month Period Ended June 30, 2008, Compared with the Three-Month Period Ended June 30, 2007

### C4I Segment

**Revenues** Revenues increased \$66.2 million, or 22.2%, to \$364.6 million for the three-month period ended June 30, 2008, as compared with the corresponding period in the prior year. The increase in revenue was primarily attributable to increased shipments of certain rugged computer systems and driver vision enhancement equipment and components for ground-based vehicles.

Revenues from rugged computer systems increased significantly over the prior year due to increased funding and accelerated customer delivery requirements to supply troops in theatre. Driver vision enhancement equipment and components also increased as a result of elevated priority placed on the program by the customer to assist in increasing combat vehicle drivers' vision capability, survivability and mobility, which resulted in incremental customer funding and accelerated delivery schedules.

Partially offsetting overall higher revenues were lower shipments of combat display workstations and replacement video display modules. Revenue from combat display workstations was lower as a result of decreased demand during the current year. Replacement video display modules revenue decreased as a result of the contract being substantially completed during the prior year.

**Operating income** Operating income increased \$4.9 million, or 15.2%, to \$36.8 million, as compared with the corresponding period in the prior year. The increase in operating income was attributed primarily to the increase in revenue. Operating margin decreased 60 basis points to 10.1% largely due to cost growth on signal intelligence software, certain sidecar cable assemblies and on the development of certain switchboard programs. Partially offsetting the overall lower operating margin was increased volume and profitability on certain driver vision enhancement equipment and components programs as a result of increased volume-driven efficiencies.

### RSTA Segment

**Revenues** Revenues increased \$104.5 million, or 68.1%, to \$258.1 million for the three-month period ended June 30, 2008, as compared with the corresponding period in the prior year. The increase in revenue was primarily attributable to greater shipments of driver vision enhancement equipment for ground-based vehicles and TWS II. Partially offsetting the overall increase in revenue was lower volume on a certain firepower enhancement program.

Revenues from driver vision enhancement equipment increased significantly as a result of elevated priority placed on the program by the customer to assist in increasing combat vehicle drivers' vision capability, survivability and mobility, which resulted in increased funding and accelerated delivery schedules. In addition, TWS II shipments increased due to the delay of shipments on the program in the prior year until the second quarter of fiscal 2008. Partially offsetting the increases was lower volume from a certain firepower enhancement program as the program was substantially completed in the prior fiscal year.

**Operating Income** Operating income increased \$10.0 million, or 63.7%, to \$25.7 million as compared to the corresponding period in the prior year. Operating margin experienced a slight decrease of 20 basis points for the three-month period ended June 30, 2008, as compared with the corresponding period in the prior year. The increase in operating income was primarily attributed to the overall increase in revenue. Operating margin decreased primarily due to the increase in TWS II deliveries during the quarter. As a result of cost growth related to prior-period design changes, prospective TWS II deliveries will be recorded at or near break-even resulting in a dilution of overall operating margin for the segment. Partially offsetting the decreased profitability were increased margins

on certain ground-based target acquisition and missile control subsystems as a result of volume-driven production efficiencies.

#### **Sustainment Systems Segment**

**Revenue** Revenues increased \$35.6 million, or 31.8%, to \$147.7 million for the three months ended June 30, 2008, as compared with the corresponding period in the prior year. The primary drivers of the increase in revenues were increased shipments of roof assemblies for the Mine Resistant Ambush Protected Vehicle (MRAP) and for precision targeting systems. The increases were partially offset by decreased deliveries of portable surveillance and target acquisition radars.

Revenues from MRAP roof assemblies increased significantly, as compared with the corresponding period in the prior year as a result of the program commencing in the second half of fiscal 2008, as well as increased priority placed on the program by the customer. The precision targeting system revenue increase was attributed to a prior-year customer-initiated design change that resulted in production delays to adhere to the proposed changes. Production resumed during the fourth quarter of fiscal 2008 resulting in increased revenue, as compared with the corresponding prior-year period.

The increase in revenues was partially offset by decreased production revenues on portable surveillance and target acquisition radars due to the timing of shipments.

**Operating Income** Operating income increased \$5.1 million, or 48.7%, to \$15.7 million, as compared with the corresponding period in the prior year. The increase was due primarily to increased revenues and improvement on the overall results on various mobile environmental system programs, as compared with the corresponding period in the prior year. The segment's operating margin increased 120 basis points due to increased profitability on precision targeting systems and certain repair contracts for heavy equipment transport trailers, as well as an overall improvement on various mobile environmental system programs.

The precision targeting systems operating margin increased due to a favorable revenue mix consisting primarily of production type contracts. In the corresponding period in the prior year, revenue consisted primarily of less profitable service-type awards. Operating margin on repair contracts for heavy equipment transport trailers increased as a result of the receipt of additional contract awards resulting in procurement efficiencies. The increased profitability on mobile environmental system programs was attributed to redesign and rework efforts incurred during the corresponding period in the prior year, which resulted in cost growth. The design changes have been substantially completed, and the current period results have improved accordingly.

The increased operating margin was partially offset by cost growth on a certain heavy duty tank trailer program, as a result of braking issues, and on mast-mounted multi-spectral surveillance systems as a result of repairing a unit damaged during testing.

#### **Technical Services Segment**

**Revenue** Revenues increased \$9.9 million, or 5.8%, to \$181.5 million for the three-month period ended June 30, 2008, as compared with the corresponding period in the prior year. Programs with significant year-over-year revenue increases are satellite-based communication services and Rapid Response programs. Revenues from satellite-based communication services increased as a result of the commencement of program operations in the second half of fiscal 2008 to support deployed personnel. Revenues from the Rapid Response program continue to increase as a result of continued operational demand in Iraq and Afghanistan.

Largely offsetting the revenue increases were decreases in power generation and distribution equipment and certain defense communication transmission system programs as the contracts were

substantially completed in the prior year. We expect to recognize additional revenue on these programs as a result of newly awarded contracts.

**Operating Income** Operating income decreased \$0.6 million, or 6.2%, to \$9.5 million compared to the corresponding period in the prior year. Operating margin experienced a decrease of 70 basis points from the 5.9% earned in the corresponding period in the prior year. The decreased profitability was attributed to the substantial completion of the profitable power generation and distribution equipment contract during the prior year. In addition, selling, general and administrative expenses increased, as compared with the corresponding period in the prior year. The decreases were partially offset by increased revenue on the profitable satellite-based communication services program.

#### Other

Operating loss increased \$11.4 million from the prior-year corresponding period as a result of \$11.5 million in investment banking, legal and consulting expenses related to the pending merger with Finmeccanica.

#### Liquidity and Capital Resources

	Three Months Ended June 30,	
	2008	2007
	(in thousands)	
Net cash (used in) provided by operating activities	\$ (7,875)	\$ 527
Net cash used in investing activities	\$ (19,690)	\$ (13,889)
Net cash provided by (used in) financing activities	\$ 1,043	\$ (48,450)

**Operating activities** During the quarter ended June 30, 2008, we used \$7.9 million of operating cash flow, as compared to the \$0.5 million of operating cash flow generated in the corresponding period in the prior year. Net earnings increased \$10.2 million to \$35.4 million. Non-cash adjustments to reconcile net earnings to cash flows from operating activities decreased \$9.3 million over the corresponding period in the prior year, driven primarily by a decrease in deferred income taxes of \$11.9 million, offset in part by increases in stock-based compensation and depreciation and amortization.

Cash used resulting from changes in assets and liabilities was \$66.7 million for the quarter. Inventories increased \$48.6 million during the period, primarily driven by the TWS II program as we continued to procure new material to meet delivery schedule requirements. The remaining increase in inventory consisted primarily of costs incurred on tactical generator programs to meet prospective delivery requirements and an increase in combat display workstations inventory. Accrued expenses and other current liabilities decreased \$14.8 million driven primarily by a decrease in the accrual for unrecognized tax benefits and payments for incentive compensation. The pension and postretirement benefit liability decreased \$7.1 million, as payments exceeded pension expense for the period. Prepaid expenses and other current assets and other, net used \$3.0 million and \$0.8 million of cash, respectively, for the quarter.

Cash provided from changes in assets and liabilities resulted from decreases in accounts receivable of \$26.3 million and an increase in customer advances of \$24.1 million. The cash provided by accounts receivable resulted from increased cash collections at various operating units. The cash generated from customer advances resulted from payments received on our satellite-based communication network and on our Horizontal Technology Integration programs.

## Edgar Filing: DRS TECHNOLOGIES INC - Form 10-Q

**Investing activities** For the three-month period ended June 30, 2008, we used \$19.7 million for capital asset expenditures, as compared with \$13.9 million in the prior year. We expect capital expenditures of approximately \$100 million to \$110 million in fiscal 2009.

**Financing activities** For the three months ended June 30, 2008, financing activities provided net cash of \$1.0 million, compared with \$48.5 million utilized in the prior-year first quarter. Proceeds received from the exercise of stock options were offset by payments of long-term debt and dividends. In the prior year, we repaid \$51.3 million in long-term debt.

Simultaneously with the closing of our acquisition of Engineered Support Systems, Inc. (ESSI), on January 31, 2006 we entered into an amended and restated credit facility for up to an aggregate amount of \$675.0 million with a syndicate of lenders (the Credit Facility), replacing our previously existing credit facility. The Credit Facility consists of a \$400.0 million senior secured revolving line of credit and a \$275.0 million senior secured term loan. We are permitted, on no more than two occasions, to increase the aggregate amount of the Credit Facility by up to \$250.0 million, subject to certain restrictions. Any increase in the aggregate amount of the Credit Facility may be borrowed in the form of either additional term loans or available amounts under the revolving line of credit. The Credit Facility is guaranteed by substantially all of DRS's domestic subsidiaries. In addition, it is collateralized by liens on substantially all of the assets of our subsidiary guarantors, certain of DRS's other subsidiaries' assets and by a pledge of a portion of certain of our non-guarantor subsidiaries' capital stock.

From time to time, we enter into standby letters-of-credit and bank guarantee agreements with financial institutions and customers, primarily relating to the guarantee of our future performance on certain contracts to provide products and services and to secure advance payments we have received from our customers. As of June 30, 2008, \$29.0 million was contingently payable under letters of credit and bank guarantees. Of this amount, approximately \$0.1 million and \$0.5 million in letters of credit and bank guarantees, respectively, were issued under a previous credit agreement and by a bank agreement for our U.K. subsidiary, respectively, and are not considered when determining the availability under our revolving line of credit. At June 30, 2008, we had \$371.6 million of availability under our revolving line of credit.

On March 29, 2006, DRS Technologies Canada Company (DRS Canada) established a five-year senior secured term loan (Canadian Term Loan) for approximately \$9.9 million (C\$11.5 million), maturing on April 1, 2011. The weighted average interest rate on the term loan was 4.75% as of June 30, 2008 (5.25% as of March 31, 2008). The carrying value of the Canadian Term Loan increased \$0.1 million during the three months ended June 30, 2008, as a result of the strengthening of the Canadian dollar, compared with the U.S. dollar during that period.

On October 30, 2003, we issued \$350.0 million aggregate principal amount of 6<sup>7</sup>/<sub>8</sub>% senior subordinated notes, due November 1, 2013 (the October 2003 Notes). The net proceeds of the October 2003 Notes, together with a portion of our available cash and initial borrowings under the then existing credit facility, were used to fund the acquisition of Integrated Defense Technologies, Inc. (IDT), repay certain of DRS's and IDT's outstanding indebtedness, and pay related fees and expenses. The October 2003 Notes were issued under an indenture with The Bank of New York. Subject to a number of exceptions, the indenture restricts our ability and the ability of our subsidiaries to incur more debt, pay dividends and make distributions, make certain investments, repurchase stock, create liens, enter into transactions with affiliates, enter into sale lease-back transactions, merge or consolidate, and transfer or sell assets. The October 2003 Notes are unconditionally guaranteed, jointly and severally, by DRS's current and future wholly-owned domestic subsidiaries. The foreign subsidiaries and certain domestic subsidiaries of DRS do not guarantee the October 2003 Notes.

On December 23, 2004, we issued an additional \$200.0 million aggregate principal amount of 6<sup>7</sup>/<sub>8</sub>% senior subordinated notes, due November 2013 (the December 2004 Notes). The December 2004 Notes

were offered as additional debt securities under our indenture with the Bank of New York with identical terms and the same guarantors as the October 2003 Notes.

On January 31, 2006, in connection with the acquisition of ESSI, we issued \$900.0 million of new debt securities, including \$350.0 million aggregate principal amount of 6<sup>5</sup>/<sub>8</sub>% senior notes due 2016, \$250.0 million aggregate principal amount of 7<sup>5</sup>/<sub>8</sub>% senior subordinated notes due 2018 (collectively called the January 2006 Notes) and \$300.0 million aggregate principal amount of 2.0% convertible senior notes due 2026 (Convertible Notes). On February 8, 2006, we sold an additional \$45.0 million of Convertible Notes pursuant to an overallotment option exercised by the initial purchasers of the Convertible Notes. The net proceeds of the January 2006 Notes and the Convertible Notes, together with a portion of our available cash and initial borrowings under the Credit Facility, were used to fund the ESSI acquisition, repay certain of ESSI's outstanding indebtedness, and pay related fees and expenses.

The January 2006 Notes are unsecured. The 7<sup>5</sup>/<sub>8</sub>% senior subordinated notes rank behind the Credit Facility, the 6<sup>5</sup>/<sub>8</sub>% senior notes, the Convertible Notes and trade payables, and are *pari passu* with the 6<sup>7</sup>/<sub>8</sub>% senior subordinated notes. The January 2006 Notes were issued under indentures with The Bank of New York. Subject to a number of exceptions, the indentures restrict our ability and the ability of our subsidiaries to incur more debt, pay dividends and make distributions, make certain investments, repurchase stock, create liens, enter into transactions with affiliates, enter into sale lease-back transactions, merge or consolidate, and transfer or sell assets. The January 2006 Notes are unconditionally guaranteed, jointly and severally, by certain of our existing and future domestic subsidiaries.

On or prior to February 1, 2010, the Convertible Notes may be converted by the holder into cash and, if applicable, shares of our common stock under certain circumstances (Conversion Rights) outlined in the indenture agreement. As of June 30, 2008 one of these Conversion Rights was triggered because the average trading price for the Convertible Notes was less than 103% of the average of the closing sale price of our common stock during the consecutive five trading-day period ended June 30, 2008. Consequently, we classified the Convertible Notes as current as of June 30, 2008. In the event of conversion, we would satisfy the bond principal payment using available cash on hand and borrowings under our revolving line of credit and would settle the conversion value utilizing shares of our common stock.

Certain of the Company's debt arrangements contain customary representations, warranties and default provisions, as well as restrictions that, among other things, limit the amount of debt that the Company may have outstanding. As of June 30, 2008, the Company was in compliance with all covenants.

Accrued interest expense at June 30, 2008 and March 31, 2008 was \$29.2 million and \$29.8 million, respectively.

Based upon our anticipated level of future operations, we believe that our existing cash and cash equivalents balances and our cash generated from operating activities, together with available borrowings under our amended and restated senior secured credit facility, will be adequate to meet our anticipated requirements for working capital, capital expenditures, commitments, research and development expenditures, contingent purchase prices, program and other discretionary investments, and interest and principal payments for the foreseeable future. There can be no assurance, however, that our business will continue to generate cash flow at current levels. If we are unable to generate sufficient cash flow from operations to service our debt, we may be required to sell assets, reduce capital expenditures, refinance all or a portion of our existing debt or obtain additional financing. Our ability to make scheduled principal payments or to pay interest on or to refinance our indebtedness depends on our future performance and financial results, which, to a certain extent, are subject to general conditions in or affecting the defense industry and to general economic, political, financial,

competitive, legislative and regulatory factors beyond our control. There can be no assurance that sufficient funds will be available to enable us to service our indebtedness, make necessary capital expenditures or to make discretionary investments.

**Dividends** On May 12, 2008, the Board of Directors declared a \$0.03 per common share cash dividend, payable on June 30, 2008 to stockholders of record as of June 13, 2008. Cash dividends paid for the three-month period ended June 30, 2008 were \$1.2 million. On August 7, 2008, the Board of Directors declared a \$0.03 per common share cash dividend, payable on September 30, 2008 to stockholders of record as of September 15, 2008.

**Free cash flow** Free cash flow represents net cash provided by operating activities less capital expenditures. Free cash flow for the three-month period ended June 30, 2008 was a deficit of \$27.6 million, or \$14.2 million less than a deficit of \$13.4 million in the corresponding period in the prior year. See "Use of Non-GAAP Financial Measures" below for additional discussion and information.

**EBITDA** Net earnings before net interest and related expenses (primarily the amortization and write-off of debt premium and issuance costs), income taxes, depreciation and amortization (EBITDA) for the three-month period ended June 30, 2008 were \$95.2 million, or \$9.1 million more than the \$86.1 million in the corresponding period in the prior year. See "Use of Non-GAAP Financial Measures" below for additional discussion and information.

**Off-Balance Sheet Financing Arrangements** We have \$345 million of 2% senior convertible notes with a conversion price of \$59.70 per share. Upon conversion, we would satisfy our obligation to convert the notes by delivering to the holders cash for the principal amount of the notes and stock for the value of the notes in excess of the principal amount of the notes, as defined in the convertible debt agreement. The number of shares potentially issuable upon conversion are reflected in our diluted earnings per share for three month period ended June 30, 2008.

In addition, there are 2.1 million stock options outstanding to purchase DRS common stock at a weighted average exercise price of \$36.79 per share and 0.6 million of non-vested stock awards outstanding at June 30, 2008 that represent additional potential dilution.

We have not entered into any other off-balance sheet financing arrangements.

**Contractual Obligations** Our contractual obligations and commitments principally include obligations associated with our outstanding indebtedness, future minimum operating lease obligations, acquisition earn-outs and purchase obligations. Except as discussed below, the disclosures relating to our contractual obligations in our Annual Report on Form 10-K for the year ended March 31, 2008 have not changed materially since we filed that report.

Based upon the expiration of statutes of limitations and/or the conclusion of tax examinations in several jurisdictions, we believe it is reasonably possible that the total amount of liability for unrecognized tax benefits may decrease by up to \$3.0 million within twelve months of June 30, 2008. We are unable to reasonably determine any amounts for years subsequent to June 30, 2008. See Note 4, Income Taxes in the notes to the unaudited condensed consolidated financial statements contained in this report.

**Backlog** Funded backlog represents products or services that our customers have committed by contract to purchase from us. Due to the general nature of defense procurement and contracting, the operating cycle for our military business typically has been long term. Military backlog currently consists of various production and engineering development contracts with varying delivery schedules and project timetables. Our backlog also includes certain commercial off-the-shelf (COTS)-based systems for the military, which have shorter delivery times. Accordingly, revenues for a particular year,



or year-to-year comparisons of reported revenues and related backlog positions, may not be indicative of future results. Backlog at June 30, 2008 was \$3.72 billion, as compared with \$3.61 billion at March 31, 2008. We booked \$1.07 billion in new orders for the three-month period ended June 30, 2008.

**Internal Research and Development** In addition to customer-funded research and development, we also engage in internal research and development. These expenditures reflect our continued investment in new technology and diversification of our products. Expenditures for internal research and development for the three-month periods ended June 30, 2008 and 2007 were \$16.6 million and \$11.5 million, respectively.

**Use of Non-GAAP Financial Measures** Certain disclosures in this document include "non-GAAP (Generally Accepted Accounting Principles) financial measures." A non-GAAP financial measure is defined as a numerical measure of our financial performance that excludes or includes amounts so as to be different than the most directly comparable measure calculated and presented in accordance with GAAP in our Consolidated Balance Sheets, Statements of Earnings or Statements of Cash Flows. The components of EBITDA and a reconciliation of EBITDA and "free cash flow" with the most directly comparable GAAP measure follows:

	<b>Three Months Ended June 30,</b>	
	<b>2008</b>	<b>2007 (Restated)</b>
	<b>(in thousands)</b>	
Net earnings	\$ 35,405	\$ 25,204
Income taxes	16,919	14,260
Interest income	(300)	(559)
Interest and related expenses	23,471	28,710
Depreciation and amortization	19,730	18,513
EBITDA(A)	95,225	86,128
Income taxes	(16,919)	(14,260)
Interest income	300	559
Interest and related expenses	(23,471)	(28,710)
Deferred income taxes	(1,581)	10,292
Changes in assets and liabilities	(66,748)	(57,450)
Other, net	5,319	3,968
Net cash (used in) provided by operating activities	(7,875)	527
Capital expenditures	(19,691)	(13,893)
Free cash flow(B)	\$ (27,566)	\$ (13,366)

(A)

We define EBITDA as net earnings before net interest and related expenses (principally amortization and write-off of debt premium and issuance costs), income taxes, depreciation and amortization. The table above presents the components of EBITDA and a reconciliation of EBITDA to net cash provided by operating activities. EBITDA is presented as additional information because we believe it to be a useful indicator of our debt capacity and our ability to service our debt. EBITDA is not a substitute for operating income, net earnings or cash flows from operating activities, as determined in accordance with GAAP. EBITDA is not a complete net cash flow measure because EBITDA is a measure of liquidity that does not reflect cash flows from discontinued operations, and does not include reductions for cash payments for an entity's obligation to service debt, fund working capital, business acquisitions and capital expenditures, and

## Edgar Filing: DRS TECHNOLOGIES INC - Form 10-Q

pay income taxes. Rather, EBITDA is one potential indicator of an entity's ability to fund these cash requirements. EBITDA also is not a complete measure of an entity's profitability because it does not include costs and expenses for depreciation and amortization, interest and related expenses and income taxes, and it also does not include the results of operations of discontinued operations. EBITDA, as we defined it, may differ from similarly named measures used by other entities and, consequently, could be misleading unless all entities calculate and define EBITDA in the same manner.

(B)

Free cash flow is defined as net cash (used in) provided by operating activities less capital expenditures. We disclose free cash flow because we believe that it is useful in evaluating our financial performance and measuring cash flows generated that are available for investing and financing activities. We believe that the most directly comparable GAAP financial measure to free cash flow is net cash (used in) provided by operating activities. Free cash flow represents cash generated after paying for interest on borrowings, income taxes, capital expenditures and changes in working capital, but before repaying outstanding debt, investing cash to acquire businesses and making other strategic investments, and it does not reflect cash flows of discontinued operations. Thus, key assumptions underlying free cash flow are that we will be able to refinance our existing debt when it matures with new debt and that we will be able to finance any new acquisitions we make by raising new debt or equity capital. We also use free cash flow as a performance measure and a component of our management incentive compensation program. Free cash flow, as we define it, may differ from similarly named measures used by other entities and, consequently, could be misleading unless all entities calculate and define free cash flow in the same manner.

### OTHER MATTERS

#### *New Accounting Pronouncements*

New accounting pronouncements have been issued, which are not effective until after June 30, 2008. For further discussion of new accounting standards, see Note 19 to our Consolidated Financial Statements in Item 1.

#### **Item 3. Quantitative and Qualitative Disclosures about Market Risk**

##### **Market Risk**

See Part II, Item 7A, "Quantitative and Qualitative Disclosures About Market Risk," of the Company's Annual Report on Form 10-K for the fiscal year ended March 31, 2008 for a discussion of the Company's exposure to market risks.

#### **Item 4. Controls and Procedures**

**(a) Disclosure Controls and Procedures** The Company's management, with the participation of the Company's Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of the Company's disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act)) as of the end of the period covered by this report. Based on such evaluation, the Company's Chief Executive Officer and Chief Financial Officer have concluded that, as of the end of such period, the Company's disclosure controls and procedures are effective in recording, processing, summarizing and reporting, on a timely basis, information required to be disclosed by the Company in the reports that it files or submits under the Exchange Act.

**(b) Management's Report on Internal Control Over Financial Reporting** As of March 31, 2008, management had assessed the effectiveness of the Company's internal control over financial reporting based on the framework established in "Internal Control Integrated Framework" issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on this assessment, management had identified a material weakness. A material weakness is a deficiency or a combination of deficiencies in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the Company's annual or interim consolidated financial statements will not be prevented or detected on a timely basis. Based on the aforementioned assessment, the following material weakness was identified in the Company's internal control over financial reporting for the fiscal year ended March 31, 2008:

The Company did not design and maintain effective policies and procedures to ensure that operating unit finance personnel assessed the impact of subsequent events from the fiscal period end date to the Company's Securities and Exchange Commission financial statement filing date. The lack of effective controls over accounting for subsequent events resulted in the restatement of our fiscal 2007 consolidated financial statements to reflect a contract loss that was previously recorded in the first quarter of fiscal 2008.

Subsequent to March 31, 2008, but effective for the fourth quarter of fiscal 2008, management required every operating unit to perform a subsequent events assessment that considers the financial statement impact of events occurring after the quarter-end date, but before the Company's anticipated filing date of its financial statements. In addition to re-asserting the representations made in an original representation letter (typically due 20 days after period-end), business unit management is required to pay particular attention to the accuracy of program estimates-at-completion, collectability of billed and unbilled accounts receivable, recoverability of pre-contract costs, the carrying value or classification of assets and liabilities, and any operating irregularities. This process is now in place and is occurring quarterly.

There have not been any changes in the Company's internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during the three months ended June 30, 2008 that materially have affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

## PART II. OTHER INFORMATION

### Item 1. Legal Proceedings

Various legal actions, claims, assessments and other contingencies, including certain matters described below, are pending against us and certain of our subsidiaries. These matters are subject to many uncertainties, and it is possible that some of these matters ultimately could be decided, resolved or settled adversely. We have recorded accruals totaling \$3.0 million at June 30, 2008 and March 31, 2008 for losses related to those matters that we consider to be probable and that can be reasonably estimated (certain legal and environmental matters are discussed in detail below). Although, at June 30, 2008, the precise amount of liability that may result from those matters for which we have recorded accruals is not ascertainable, we believe that any amounts exceeding our recorded accruals should not materially affect our financial condition or liquidity. It is possible, however, that the ultimate resolution of those matters could result in a material adverse effect on our results of operations and/or cash flows from operating activities for a particular reporting period.

Some environmental laws, such as the Comprehensive Environmental Response, Compensation and Liability Act of 1980 (also known as CERCLA or the Superfund law) and similar state statutes, can impose liability upon former owners or operators for the entire cost of investigating and remediating contaminated sites regardless of the lawfulness of the original activities that led to the contamination. In July 2000, prior to its acquisition by Integrated Defense Technologies, Inc., Tech-Sym Corporation, an indirect subsidiary of the Company, received a Section 104(e) Request for Information from the National Park Service (NPS), pursuant to CERCLA, regarding a site known as the Orphan Mine site in the Grand Canyon National Park, Arizona. The Orphan Mine, which was operated by an alleged predecessor to Tech Sym between 1956 and 1967, is the subject of an NPS investigation regarding the presence of residual radioactive materials and contamination. Following Tech-Sym's response to the Request for Information, the NPS directed Tech Sym and another alleged former owner/operator to perform an Engineering Evaluation and Cost Analysis (EE/CA) of the site. Tech Sym made a good faith offer to conduct the EE/CA, but the NPS rejected this offer and may perform the EE/CA itself, or negotiate directly with another potentially responsible party for the performance of the EE/CA. Following completion of the EE/CA, the NPS may direct one or more of the potentially responsible parties to perform any remediation that may be required by CERCLA. We believe that we have legitimate defenses to Tech-Sym's potential liability and that there are other potentially responsible parties for the environmental conditions at the site, including the U.S. government as owner, operator and arranger at the site. The potential liability associated with this matter can change substantially, due to such factors as additional information on the nature or extent of contamination, methods of remediation that might be recommended or required, changes in the apportionment of costs among the responsible parties and other actions by governmental agencies or private parties.

In connection with our acquisition of ESSI in January 2006, we have been made aware of certain legal actions, claims, assessments and other contingencies, including those described below.

In December 2004, ESSI was notified by the Enforcement Division of the SEC of the issuance of a formal order directing a private investigation and was notified that the SEC had issued subpoenas to various individuals associated with ESSI to produce certain documents. The SEC staff also requested that ESSI produce certain documents in connection with the investigation. The subpoenas related to trading in ESSI stock around ESSI's earnings releases in 2003 and to the adequacy of certain disclosures made by ESSI regarding related-party transactions in 2002 and 2003 involving insurance policies placed by ESSI through an insurance brokerage firm in which an ESSI director was a principal at the time of the transactions. In February 2007, the SEC filed a civil injunctive action in the United States District Court for the Eastern District of Missouri, Eastern Division, against a former director, officer and consultant of ESSI, alleging that he had violated the federal securities laws by "tipping" his financial advisor and close friend by sharing material, nonpublic information regarding ESSI's financial

condition shortly before certain 2003 earnings announcements. That action is scheduled for trial on December 15, 2008.

On or about September 23, 2005, the SEC staff advised ESSI's counsel that it had issued a subpoena directed to ESSI and expanded its investigation to include ESSI's disclosure of a November 2004 stop work order relating to ESSI's Deployable Power Generation and Distribution Systems (DPGDS) program for the U.S. Air Force and relating to trading in ESSI stock by certain individuals associated with ESSI. In connection with the foregoing SEC investigation, ESSI and certain of its directors and officers have provided information and/or testimony to the SEC. ESSI has received no additional subpoenas or requests for information from the SEC on these subject matters since May 2006.

In January 2006, ESSI was informed that the Office of the U.S. Attorney for the Eastern District of Missouri was initiating an investigation into ESSI's disclosure of the DPGDS stop-work order and into trading in ESSI stock by ESSI insiders, which preceded such disclosure. The U.S. Attorney's office advised ESSI that although it considered ESSI to be a subject of its investigation, ESSI was not a target. In connection with this investigation, the U.S. Attorney's office issued ESSI a subpoena requesting specified information, which ESSI has furnished. ESSI has received no additional subpoenas or requests for information from the U.S. Attorney's office on these subject matters since May 2006.

In May 2006, we were advised that the Enforcement Division of the SEC and the U.S. Attorney's office each had expanded its investigation to include possible "backdating" of the timing of option grants at ESSI prior to the time ESSI was acquired by us. As a part of its investigation, the SEC issued subpoenas to certain former officers and employees of ESSI to provide testimony and produce certain documents.

In February 2007, the SEC filed civil injunctive actions in the United States District Court for the Eastern District of Missouri, Eastern Division, alleging that ESSI's former Chief Financial Officer and former Controller had each participated in a backdating scheme. Also in February 2007, the SEC reported that ESSI's former Controller had settled its action against him by consenting to disgorgement, financial penalties, an officer and director bar and a permanent suspension from practicing before the SEC as an accountant. In July 2007, the SEC filed civil injunctive actions in the United States District Court for the Eastern District of Missouri, Eastern Division, alleging that ESSI's former Chairman of the Board and Chief Executive Officer and his son (who was also a member of ESSI's Board of Directors and Compensation Committee) each participated in a backdating scheme. The pending SEC actions have been consolidated and stayed at the request of the U.S. Attorney's office pending resolution of related criminal proceedings.

In March 2007, ESSI's former Controller pleaded guilty to a one-count information brought by the office of the United States Attorney for the Eastern District of Missouri, charging him with making false statements to the government. In connection with his plea, this former ESSI executive admitted that a number of documents filed by ESSI with the SEC contained the materially false statement that the option price of shares subject to the ESSI stock option plan was the closing price of the stock on the date the options were awarded.

In March 2007, ESSI's former Chief Financial Officer was indicted by the grand jury of the United States District Court for the Eastern District of Missouri relating to the backdating of the timing of stock options at ESSI prior to the time ESSI was acquired by DRS. In July 2007, ESSI's former Chairman of the Board and Chief Executive Officer and his son (who was also a member of ESSI's Board of Directors and Compensation Committee) were each indicted on similar charges. The July 2007 superseding indictment charges these former ESSI officers and directors with twelve counts of fraud based on allegations that they backdated stock options on at least eight occasions between 1996 and 2002.

## Edgar Filing: DRS TECHNOLOGIES INC - Form 10-Q

In July 2008, ESSI's former Chairman of the Board and Chief Executive Officer and former Chief Financial Officer each pleaded guilty to falsifying (or causing the falsification of) the records of a publicly traded company. In connection with their respective pleas, ESSI's former Chairman of the Board and Chief Executive Officer admitted that he knowingly and intentionally signed falsely dated stock option award letters and ESSI's former Chief Financial Officer admitted that he caused such falsely dated award letters to be issued to stock option recipients. Under their respective plea agreements, criminal penalties are to be determined in accordance with the federal sentencing guidelines (which provide for a presumptive incarceration range of 15 to 21 months) but may be adjusted downward by the sentencing judge. ESSI's former Chairman of the Board and Chief Executive Officer and former Chief Financial Officer also agreed to make restitution payments of approximately \$7.9 million and \$1.8 million, respectively. The remaining charges against these former executives and the indictment issued against ESSI's former Chairman of the Board and Chief Executive Officer's son (who was also a member of ESSI's Board of Directors and Compensation Committee) were dismissed.

Although ESSI continues to be a subject of the U.S. Attorney's office's investigation, the U.S. Attorney's office has advised us that ESSI is not a target. Because the events being investigated occurred prior to the time of our acquisition of ESSI, the U.S. Attorney's office has further advised us that it considers DRS to be a witness, not a subject or target of its investigation.

We are committed to full cooperation with regard to the foregoing investigations and proceedings. We are unable to determine at this time the impact, if any, these matters could have on us.

In September 2006, the Internal Revenue Service commenced an audit of ESSI's Federal tax returns for the tax periods ended October 31, 2004, October 31, 2005 and January 31, 2006. Thereafter, the Internal Revenue Service agreed, subject to Congressional approval, to close these audits based on ESSI's agreement to accept certain proposed adjustments (primarily involving the reversal of certain compensation deductions taken during these tax years) and a corresponding assessment of approximately \$11.3 million (exclusive of interest) which was previously accrued. In September 2007, we received written confirmation from the Congressional Joint Committee on Taxation that it took no exception to the proposed adjustments.

In August 2007, a shareholder derivative complaint was filed in the United States District Court for the Eastern District of Missouri against ESSI's former Chairman of the Board and Chief Executive Officer, his son (who was also a member of ESSI's Board of Directors and Compensation Committee), ESSI's former Chief Financial Officer and ESSI's former Controller relating to the alleged backdating of stock options prior to ESSI's acquisition by DRS. The complaint also contains claims against us as a nominal defendant and against each of the current members of our Board of Directors relating to the alleged backdating of ESSI stock options and the ESSI acquisition. We believe the claims made against us and our current Directors are without merit. The U.S. Attorney's office has moved to intervene and stay the case pending resolution of the related criminal charges against the individual ESSI defendants. DRS and the DRS Directors have moved to dismiss the case on substantive and jurisdictional grounds. Those motions are pending.

In January 2008, we received an inquiry from the Australian Competition and Consumer Commission (ACCC) related to one of our subsidiaries, DRS Training & Control Systems, Inc. The ACCC has requested documents and information regarding allegations of possible anticompetitive activity in violation of the Australian Trade Practices Act. In April 2008, we provided the documents and information requested by the ACCC. We have commenced an internal investigation involving this matter, but are currently unable to determine the timing or the impact, if any, that the matter may have on us.

In May 2008, we were notified that the NYSE Regulation Inc.'s Market Trading Analysis Department (the NYSE) and the SEC had each commenced independent inquiries regarding trading in DRS securities prior to the public announcement that Finmeccanica and the Company had entered into

a definitive merger agreement pursuant to which Finmeccanica had agreed to acquire us for \$81.00 per share subject to the terms thereof. In each case, we were asked to provide certain documents and information. We were advised by the SEC that its informal inquiry should not be construed as an indication by the SEC or its staff that any violations of law have occurred or as an adverse reflection upon any person or security. Similarly, the NYSE advised us that it was engaged in a fact gathering process and that no inference of impropriety should be inferred.

In May 2008, a plaintiff filed a putative class action lawsuit against us and the members of our board of directors in the Superior Court of the State of New Jersey, challenging the transactions contemplated by the merger agreement and alleging breaches of fiduciary duty. In June 2008, the defendants filed a motion to dismiss the complaint in its entirety, a motion for a protective order to stay discovery, and a motion to transfer the action from the Law Division to the Chancery Division, General Equity. On July 11, 2008, the plaintiff filed a motion for leave to amend his complaint. The Court granted this motion on July 16, 2008, transferred the action from the Law Division to the Chancery Division, General Equity, and stayed certain matters in the case. The amended complaint asserts a claim for breach of fiduciary duties against the director defendants and a claim for aiding and abetting breach of fiduciary duties against us and our general counsel. The amended complaint alleges, among other things, that the proposed transaction arises out of a flawed process. The plaintiff also alleges that our preliminary proxy statement, filed with the SEC on June 13, 2008, contained misleading disclosures and/or omits certain material information. The plaintiff seeks, among other things, an order enjoining the defendants from consummating the transaction and directing the individual defendants to exercise their fiduciary duties to obtain a transaction that is in the best interests of our shareholders. On July 25, 2008, the defendants moved to dismiss the amended complaint in its entirety for failure to state a claim. We believe that the claims asserted by the plaintiff in the amended complaint are wholly without merit and intend to defend vigorously against the action.

#### **Item 1A. Risk Factors**

In addition to the information set forth in this report, you should carefully consider the factors discussed in Part I, "Item 1A. Risk Factors" in our Annual Report on Form 10-K for the year ended March 31, 2008, which could materially affect our business, financial condition or future results. The risks described in our Annual Report on Form 10-K are not the only risks facing our Company. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business, financial condition and/or operating results.

**Items 2, 3 and 4 are not applicable and have been omitted.**

#### **Item 5. Other Information**

On August 7, 2008, the Company named Robert F. Mehmel, age 46, President, retaining the position of Chief Operating Officer of the corporation. As President he will continue to report to Mark S. Newman who previously served in that capacity since 1994. Mr. Newman retains the positions of Chairman of the Board and Chief Executive Officer of DRS.

Mr. Mehmel has been our Executive Vice President, Chief Operating Officer, since May 2006. He joined us as Executive Vice President, Business Operations and Strategy, in January 2001. Before joining DRS, he was Director, Corporate Development, at Jabil Circuit, Inc. Prior to that, he was Vice President, Planning, at L-3 Communications Corporation from its inception in April 1997 until June 2000. Earlier, Mr. Mehmel held various positions in divisional and corporate financial management with Lockheed Martin Corporation, Loral Corporation and Lear Siegler, Inc.

**Item 6. Exhibits**

(a) Exhibits

<b>Exhibit No.</b>	<b>Description</b>
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 of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2*	Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

---

\*

Filed herewith



**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.

DRS TECHNOLOGIES, INC.

/S/ RICHARD A. SCHNEIDER

---

Richard A. Schneider  
*Chief Financial Officer*

53

---

Date: August 8, 2008

QuickLinks

[DRS TECHNOLOGIES, INC. AND SUBSIDIARIES Index to Quarterly Report on Form 10-Q for the Quarter Ended June 30, 2008](#)

[PART I. FINANCIAL INFORMATION](#)

[Item 1. Financial Statements](#)

[DRS TECHNOLOGIES, INC. AND SUBSIDIARIES Consolidated Balance Sheets \(in thousands, except share and per-share data\) \(Unaudited\)](#)

[DRS TECHNOLOGIES, INC. AND SUBSIDIARIES Consolidated Statements of Earnings \(in thousands, except per-share data\) \(Unaudited\)](#)

[DRS TECHNOLOGIES, INC. AND SUBSIDIARIES Consolidated Statements of Cash Flows \(in thousands\) \(Unaudited\)](#)

[DRS TECHNOLOGIES, INC. AND SUBSIDIARIES Notes to the Consolidated Financial Statements \(Unaudited\)](#)

[Condensed Consolidating Balance Sheet As of June 30, 2008 \(in thousands\)](#)

[Condensed Consolidating Balance Sheet As of March 31, 2008 \(in thousands\)](#)

[Condensed Consolidating Statements of Earnings Three Months Ended June 30, 2008 \(in thousands\)](#)

[Condensed Consolidating Statements of Earnings Three Months Ended June 30, 2007 \(in thousands\) \(Restated\)](#)

[Condensed Consolidating Statements of Cash Flows Three Months Ended June 30, 2008 \(in thousands\)](#)

[Condensed Consolidating Statements of Cash Flows Three Months Ended June 30, 2007 \(in thousands\)](#)

[Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations](#)

[Item 3. Quantitative and Qualitative Disclosures about Market Risk](#)

[Item 4. Controls and Procedures](#)

[PART II. OTHER INFORMATION](#)

[Item 1. Legal Proceedings](#)

[Item 1A. Risk Factors](#)

[Item 5. Other Information](#)

[Item 6. Exhibits](#)

[SIGNATURES](#)