KRATOS DEFENSE & SECURITY SOLUTIONS, INC.
Form 10-Q
August 08, 2013
Table of Contents

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

FORM 10-Q

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

For the Quarterly Period Ended June 30, 2013

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

Commission file number 001-34460

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

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

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

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

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

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

Large accelerated filer o	Accelerated filer ý

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

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

As of August 2, 2013, 57,005,546 shares of the registrant’s common stock were outstanding.

Table of Contents

KRATOS DEFENSE & SECURITY SOLUTIONS, INC.

FORM 10-Q

FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2013

INDEX

Table of Contents

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements.

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

	December 30, 2012	June 30, 2013
Assets		
Current assets:		
Cash and cash equivalents	$49.0	$49.7
Restricted cash	5.5	5.2
Accounts receivable, net	271.9	253.6
Inventoried costs	94.3	85.3
Prepaid expenses	17.4	18.4
Other current assets	17.3	5.6
Total current assets	455.4	417.8
Property, plant and equipment, net	85.6	83.5
Goodwill	596.4	596.4
Intangible assets, net	106.1	87.8
Other assets	40.4	36.8
Total assets	$1,283.9	$1,222.3
Liabilities and Stockholders’ Equity		
Current liabilities:		
Accounts payable	$83.6	$64.9
Accrued expenses	46.4	39.1
Accrued compensation	47.8	39.8
Accrued interest	6.3	6.1
Billings in excess of costs and earnings on uncompleted contracts	43.7	45.6
Deferred income tax liability	28.9	29.0
Other current liabilities	22.1	14.1
Total current liabilities	278.8	238.6
Long-term debt principal, net of current portion	629.7	629.3
Long-term debt premium	18.7	16.6
Other long-term liabilities	32.6	29.7
Total liabilities	959.8	914.2
Commitments and contingencies		
Stockholders’ equity:		
Preferred stock, $0.001 par value, 5,000,000 shares authorized, 0 shares outstanding at December 30, 2012 and June 30, 2013	—	—
Common stock, $0.001 par value, 195,000,000 shares authorized; 56,613,024 and 56,675,080 shares issued and outstanding at December 30, 2012 and June 30, 2013, respectively	—	—
Additional paid-in capital	847.1	850.9
Accumulated other comprehensive loss	(0.8)	(0.7)
Accumulated deficit	(522.2)	(542.1)
Total stockholders' equity	324.1	308.1
Total liabilities and stockholders’ equity	$1,283.9	$1,222.3

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

Table of Contents

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

	Three Months Ended		Six Months Ended	
	June 24, 2012	June 30, 2013	June 24, 2012	June 30, 2013
Service revenues	$112.1	$110.2	$214.2	$226.2
Product sales	107.7	125.0	215.1	262.3
Total revenues	219.8	235.2	429.3	488.5
Cost of service revenues	86.7	83.3	166.5	171.9
Cost of product sales	75.4	91.5	147.7	190.4
Total costs	162.1	174.8	314.2	362.3
Gross profit	57.7	60.4	115.1	126.2
Selling, general and administrative expenses	42.6	48.0	86.4	97.1
Merger and acquisition expenses	1.5	(2.6)	2.4	(2.5)
Research and development expenses	4.8	4.8	8.4	9.7
Unused office space and other restructuring	1.4	1.3	1.4	1.6
Operating income from continuing operations	7.4	8.9	16.5	20.3
Other income (expense):				
Interest expense, net	(16.2)	(16.3)	(32.3)	(32.5)
Other income (expense), net	0.5	0.2	0.9	(0.6)
Total other expense, net	(15.7)	(16.1)	(31.4)	(33.1)
Loss from continuing operations before income taxes	(8.3)	(7.2)	(14.9)	(12.8)
Provision (benefit) for income taxes from continuing operations	6.6	(0.1)	2.5	2.7
Loss from continuing operations	(14.9)	(7.1)	(17.4)	(15.5)
Loss from discontinued operations	(2.3)	(2.5)	(2.8)	(4.4)
Net loss	$(17.2)	$(9.6)	$(20.2)	$(19.9)
Basic income (loss) per common share:				
Net loss from continuing operations	$(0.36)	$(0.12)	$(0.47)	$(0.27)
Net loss from discontinued operations	(0.05)	(0.05)	(0.07)	(0.08)
Net loss per common share	$(0.41)	$(0.17)	$(0.54)	$(0.35)
Diluted income (loss) per common share:				
Net loss from continuing operations	$(0.36)	$(0.12)	$(0.47)	$(0.27)
Net loss from discontinued operations	(0.05)	(0.05)	(0.07)	(0.08)
Net loss per common share	$(0.41)	$(0.17)	$(0.54)	$(0.35)
Weighted average common shares outstanding:				
Basic	41.7	56.6	37.1	56.6
Diluted	41.7	56.6	37.1	56.6
Comprehensive Loss				
Net loss from above	$(17.2)	$(9.6)	$(20.2)	$(19.9)
Other comprehensive income:				
	(0.2)	—	(0.2)	0.1

Change in cumulative translation adjustment				
Other comprehensive income (loss), net of tax	(0.2)	—	(0.2)	0.1
Comprehensive loss	$(17.4)	$(9.6)	$(20.4)	$(19.8)

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

Table of Contents

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

	Six Months Ended	
	June 24, 2012	June 30, 2013
Operating activities:		
Net loss	$(20.2)	$(19.9)
Less: Loss from discontinued operations	(2.8)	(4.4)
Loss from continuing operations	(17.4)	(15.5)
Adjustments to reconcile loss from continuing operations to net cash provided by operating activities from continuing operations:		
Depreciation and amortization	25.9	27.8
Deferred income taxes	1.3	—
Stock-based compensation	2.3	3.9
Amortization of deferred financing costs	2.5	2.6
Amortization of premium on Senior Secured Notes	(2.1)	(2.1)
Provision for doubtful accounts	0.3	0.2
Changes in assets and liabilities, net of acquisitions:		
Accounts receivable	11.6	18.2
Inventoried costs	(9.6)	9.2
Prepaid expenses and other assets	(3.7)	(0.1)
Accounts payable	9.4	(18.9)
Accrued compensation	(6.6)	(8.1)
Accrued expenses	0.3	(7.8)
Accrued interest payable	—	(0.3)
Billings in excess of costs and earnings on uncompleted contracts	(2.3)	1.9
Income tax receivable and payable	(1.5)	4.1
Other liabilities	(0.6)	(6.7)
Net cash provided by operating activities from continuing operations	9.8	8.4
Investing activities:		
Cash paid for acquisitions, net of cash acquired	(21.5)	1.2
Decrease in restricted cash	0.3	0.2
Proceeds from the sale of discontinued operations	—	0.4
Capital expenditures	(6.2)	(7.3)
Net cash used in investing activities from continuing operations	(27.4)	(5.5)
Financing activities:		
Proceeds from the issuance of common stock	97.0	—
Cash paid for contingent acquisition consideration	(2.5)	(2.1)
Repayment of debt	(0.5)	(0.5)
Debt issuance costs	(1.0)	—
Other	(0.3)	(0.3)
Net cash provided by (used in) financing activities from continuing operations	92.7	(2.9)
Net cash flows of continuing operations	75.1	—
Net operating cash flows of discontinued operations	1.3	0.8
Effect of exchange rate changes on cash and cash equivalents	(0.3)	(0.1)
Net increase in cash and cash equivalents	76.1	0.7
Cash and cash equivalents at beginning of period	69.6	49.0

Cash and cash equivalents at end of period	$145.7	$49.7

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

Table of Contents

KRATOS DEFENSE & SECURITY SOLUTIONS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

Note 1. Summary of Significant Accounting Policies

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

(a) Basis of Presentation

The information as of June 30, 2013 and for the three and six months ended June 24, 2012 and June 30, 2013 is unaudited. The condensed consolidated balance sheet as of December 30, 2012 was derived from the Company’s audited consolidated financial statements at that date. In the opinion of management, these unaudited condensed consolidated financial statements include all adjustments, consisting of normal recurring adjustments necessary for a fair presentation of the Company’s financial position, results of operations and cash flows for the interim periods presented. The results have been prepared in accordance with the instructions to Form 10-Q and do not necessarily include all information and footnotes necessary for presentation in accordance with accounting principles generally accepted in the U.S. (“GAAP”). These unaudited condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and the related notes included in the Company’s audited annual consolidated financial statements for the fiscal year ended December 30, 2012, included in the Company’s Annual Report on Form 10-K filed with the U.S. Securities and Exchange Commission ("SEC") on March 12, 2013 (the “Form 10-K”). Interim operating results are not necessarily indicative of operating results expected in subsequent periods or for the year as a whole.

(b) Principles of Consolidation

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

(c) Fiscal Year

The Company has a 52/53 week fiscal year ending on the last Sunday of the calendar year, with interim fiscal periods ending on the last Sunday of each calendar quarter. The three and six month periods ended June 24, 2012 and June 30, 2013 consisted of 13 and 26 week periods, respectively. There were 53 calendar weeks in the fiscal year ended December 30, 2012 and there are 52 calendar weeks in the fiscal year ending on December 29, 2013.

(d) Accounting Estimates

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

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

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

Table of Contents

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

(e) Accounting Standards Updates

In July 2013, the FASB issued Accounting Standards Update 2013-11 ("ASU 2013-11") "Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists" which states that an unrecognized tax benefit, or a portion of an unrecognized tax benefit, should be presented in the financial statements as a reduction to a deferred tax asset for a net operating loss carryforward, a similar tax loss, or a tax credit carryforward, except as follows. To the extent a net operating loss carryforward, a similar tax loss, or a tax credit carryforward is not available at the reporting date under the tax law of the applicable jurisdiction to settle any additional income taxes that would result from the disallowance of a tax position or the tax law of the applicable jurisdiction does not require the entity to use, and the entity does not intend to use, the deferred tax asset for such purpose, the unrecognized tax benefit should be presented in the financial statements as a liability and should not be combined with deferred tax assets. The amendments in this ASU are effective for fiscal years, and interim periods within those years, beginning after December 15, 2013. The Company does not believe that the adoption of this guidance will have a material impact on its consolidated financial statements.

In February 2013, the FASB issued ASU 2013-02 "Comprehensive Income: Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income," which requires entities to provide information about the amounts reclassified out of accumulated other comprehensive income by component. In addition, entities are required to present, either on the face of the statement where net income is presented or in the notes, significant amounts reclassified out of accumulated other comprehensive income by the respective line items of net income but only if the amount is required under GAAP to be reclassified to net income in its entirety in the same reporting period. For other amounts that are not required under GAAP to be reclassified in their entirety to net income, entities are required to cross-reference to other disclosures required under GAAP that provide additional detail on these amounts. This standard is effective prospectively for reporting periods beginning after December 15, 2012. The Company adopted this standard in the quarter ended March 31, 2013, which did not have a material impact on its consolidated financial statements.

In December 2011 and February 2013, the FASB issued an amendment to the Balance Sheet topic of the Accounting Standards Codification ("ASC"), which requires entities to disclose both gross and net information about both derivatives and transactions eligible for offset in the statement of financial position and instruments and transactions subject to an agreement similar to a master netting agreement. The objective of the disclosure is to facilitate comparison between those entities that prepare their financial statements on the basis of GAAP and those entities that prepare their financial statements on the basis of International Financial Reporting Standards. This standard is effective for fiscal years, and interim periods within those years, beginning on or after January 1, 2013. Retrospective presentation for all comparative periods presented is required. Accordingly, the Company will adopt this amendment in the first quarter of fiscal year 2014. The Company does not believe that the adoption of this guidance will have a material impact on its consolidated financial statements.

Other than as noted above, there have been no changes in the Company's significant accounting policies for the six months ended June 30, 2013 as compared to the significant accounting policies described in the Form 10-K.

(f) Concentrations and Uncertainties

The Company maintains cash balances at various financial institutions, and such balances commonly exceed the $250,000 insured amount by the Federal Deposit Insurance Corporation. The Company has not experienced any losses in such accounts, and management believes that the Company is not exposed to any significant credit risk with respect to such cash and cash equivalents.

Table of Contents

Financial instruments, which subject the Company to potential concentrations of credit risk, consist principally of the Company’s billed and unbilled accounts receivable. The Company’s accounts receivable result from sales to customers within the federal government, state and local agencies and commercial customers in various industries. The Company performs ongoing credit evaluations of its commercial customers. Credit is extended based on evaluation of the customer’s financial condition, and collateral is not required. Accounts receivable are recorded at the invoiced amount and do not bear interest. See Note 11 for a discussion of the Company’s significant customers.

Note 2. Acquisitions

(a) Summary of Recent Acquisitions

Composite Engineering, Inc.

On July 2, 2012, the Company completed the acquisition of Composite Engineering, Inc. (“CEi”) for approximately $164.0 million. The purchase price, including an adjustment for working capital and cash paid to the CEi shareholders for a 338(h)(10) election, included $135.0 million in cash and 4.0 million shares of the Company's common stock, valued at $5.94 per share on July 2, 2012, or $23.8 million. $10.7 million of the cash paid was placed into an escrow account as security for CEi's indemnification obligations as set forth in the CEi purchase agreement and was reduced by $1.0 million for the working capital adjustment paid to the Company in July 2013, at which time the remaining escrow was released to the sellers. In addition, $2.5 million was paid to retire certain pre-existing CEi debt and settle pre-existing accounts receivable from CEi at its carrying and fair value of $3.0 million. The Company made an election under Section 338(h)(10) of the Internal Revenue Code, which resulted in tax deductible goodwill related to this transaction, and paid approximately $1.6 million in additional tax liability incurred by the shareholders of CEi for this election. The Company estimates that the tax deductible goodwill and intangibles is approximately $140.6 million and can be deducted for federal and California state income taxes over a 15-year period.

In connection with the completion of the CEi transaction, certain CEi personnel entered into long-term employment agreements with the Company. On July 2, 2012, the Company granted restricted stock units ("RSUs") for an aggregate of 2.0 million shares of common stock as long-term retention inducement grants to certain employees of CEi who joined Kratos. The RSUs had an estimated value of $11.9 million on the grant date, vest on the fourth anniversary of the closing of the CEi acquisition, or earlier upon the occurrence of certain events, and are being accounted for as compensation expense over such four-year period.

To fund the acquisition of CEi, on May 14, 2012, the Company sold approximately 20.0 million shares of its common stock at a purchase price of $5.00 per share in an underwritten public offering. The Company received gross proceeds of approximately $100.0 million and net proceeds of approximately $97.0 million after deducting underwriting fees and other offering expenses. The Company used the net proceeds from this offering to fund a portion of the purchase price for the acquisition of CEi. In addition, the Company used borrowings of $40.0 million from its revolving line of credit to fund the purchase price of CEi.

CEi is a vertically integrated manufacturer and developer of unmanned aerial target systems and composite structures used for national security programs. Its drones are designed to replicate some of the most lethal aerial threats facing warfighters and strategic assets. CEi's customers include U.S. agencies and foreign governments. CEi is a part of the Kratos Government Solutions ("KGS") segment.

The excess of the purchase price over the fair value of the tangible and identifiable intangible assets acquired and liabilities assumed in the acquisition was allocated to goodwill. The value of the goodwill represents the value the Company expects to be created by enabling it to strategically expand its strengths in the areas of design, engineering, development, manufacturing and production of unmanned aerial targets, and will also enable the Company to realize significant cross selling opportunities.

The transaction has been accounted for using the acquisition method of accounting, which requires, among other things, that the assets acquired and liabilities assumed be recognized at their fair values as of the acquisition date. The following table summarizes the fair values of the major assets acquired and liabilities assumed (in millions):

Table of Contents

Cash	$8.9
Accounts receivable	9.3
Inventoried costs	12.3
Other current assets	8.9
Property and equipment	8.1
Intangible assets	38.0
Goodwill	104.2
Total assets	189.7
Current liabilities	(25.7)
Net assets acquired	$164.0

The goodwill recorded in this transaction is tax deductible.

As of July 2, 2012, the expected fair value of accounts receivable approximated historical cost. The gross accounts receivable was $9.3 million, all of which is expected to be collectible. There was no contingent purchase consideration associated with the acquisition of CEi.

The amounts of revenue and operating loss of CEi included in the Company's condensed consolidated statement of operations and comprehensive income (loss) for the three and six months ended June 30, 2013 are $27.2 million and $53.1 million, and $3.6 million and $6.8 million, respectively.

Critical Infrastructure Business

On December 30, 2011, the Company acquired a critical infrastructure security and public safety system integration business (the “Critical Infrastructure Business”) for approximately $18.8 million, which includes a final agreement on the working capital adjustment.

The Critical Infrastructure Business designs, engineers, deploys, manages and maintains specialty security systems at some of the most strategic asset and critical infrastructure locations in the U.S. Additionally, these security systems are typically integrated into command and control system infrastructure or command centers. Approximately 15% of the revenues of the Critical Infrastructure Business are recurring in nature due to the operation, maintenance or sustainment of the security systems once deployed. The Critical Infrastructure Business is part of the Company's Public Safety & Security (“PSS”) segment.

The excess of the purchase price over the fair value of the tangible and identifiable intangible assets acquired and liabilities assumed in the acquisition was allocated to goodwill. The value of the goodwill represents the value the Company expects to be created by enabling it to strategically expand its strengths in the areas of homeland security solutions and will also enable the Company to realize significant cross selling opportunities and increase its sales of higher margin, fixed price products.

The transaction has been accounted for using the acquisition method of accounting, which requires, among other things, that the assets acquired and liabilities assumed be recognized at their fair values as of the acquisition date. The following table summarizes the fair values of the major assets acquired and liabilities assumed (in millions):

Accounts receivable	$23.4
Other assets	0.5
Intangible assets	2.0
Goodwill	2.6

Total assets	28.5
Current liabilities	(9.7)
Net assets acquired	$18.8

The goodwill recorded in this transaction is tax deductible.

9

Table of Contents

As of December 30, 2011, the expected fair value of accounts receivable approximated historical cost. The gross accounts receivable was $24.4 million, of which approximately $1.0 million is not expected to be collectible.

Due to the integration of the Critical Infrastructure Business with the Company's existing PSS business it is impractical to estimate the amounts of revenue and operating income (loss) included in the Company's condensed consolidated statement of operations and comprehensive income (loss).

Pro Forma Financial Information

The following tables summarize the supplemental condensed consolidated statements of operations information on an unaudited pro forma basis as if the acquisition of CEi occurred on December 26, 2011 and include adjustments that were directly attributable to the transaction or were not expected to have a continuing impact on the Company. The acquisition of CEi is included in the results of operations for the three and six months ended June 30, 2013. There are no material, nonrecurring pro forma adjustments directly attributable to the business combination included in the reported pro forma revenue and earnings for 2012. The pro forma results are for illustrative purposes only for the applicable period and do not purport to be indicative of the actual results that would have occurred had the transaction been completed as of the beginning of the period, nor are they indicative of results of operations that may occur in the future (all amounts except per share amounts are in millions):

	For the Three Months Ended June 24, 2012	For the Six Months Ended June 24, 2012
Pro forma revenues	$245.6	$478.0
Pro forma net loss before tax	(15.4)	(24.5)
Pro forma net loss	(22.0)	(27.0)
Net loss attributable to the registrant	(14.9)	(17.4)
Basic and diluted pro forma loss per share	$(0.33)	$(0.44)

The pro forma financial information reflects the elimination of acquisition related expenses incurred for the three and six months ended of $0.5 million and $0.8 million, respectively, pro forma adjustments for the additional amortization associated with finite-lived intangible assets acquired, stock compensation related to the RSUs granted in the CEi transaction, adjusted depreciation expense related to the fair value of property, plant, and equipment acquired, and the related tax expense.

These adjustments are as follows (in millions):

	For the Three Months Ended June 24, 2012	For the Six Months Ended June 24, 2012
Intangible amortization	$4.0	8.0
Net change in stock compensation expense	$0.7	1.4
Increase in weighted average common shares outstanding for shares issued and not already included in the weighted average common shares outstanding	24.0	24.0

Contingent Acquisition Consideration

In connection with certain acquisitions, the Company has agreed to make additional future payments to the seller contingent upon achievement of specific performance-based milestones by the acquired entities. Pursuant to the provisions of Topic 805, the Company will re-measure these liabilities each reporting period and record changes in the fair value in its condensed consolidated statement of operations and comprehensive income (loss). Increases or decreases in the fair value of the contingent consideration liability, which is measured as the present value of expected future cash flows, a Level 3 measurement in the fair value hierarchy (Level 3 hierarchy as defined by ASC Topic 820, Fair Value Measurements and Disclosures ("Topic 820")), can result from changes in discount periods and rates, as well as changes in the estimates on the achievement of the performance-based milestones.

Table of Contents

Pursuant to the terms of the agreement and plan of merger with DEI Services Corporation entered into on August 9, 2010 (“the DEI Agreement”), upon achievement of certain cash receipts, revenue, EBITDA and backlog amounts in 2010, 2011 and 2012, the Company was obligated to pay certain additional contingent consideration (the “DEI Contingent Consideration”). The Company has paid $5.0 million related to the DEI Contingent Consideration, with the final payment of $2.1 million paid in April 2013.

Note 3. Goodwill and Intangible Assets

(a) Goodwill

The Company performs its annual impairment test for goodwill in accordance with ASC Topic 350, Intangibles-Goodwill and Other (“Topic 350”) as of the last day of each fiscal year or when evidence of potential impairment exists.

The Company assesses goodwill for impairment at the reporting unit level, which is defined as an operating segment or one level below an operating segment, referred to as a component. The Company determines its reporting units by first identifying its operating segments, and then assessing whether any components of these segments constitute a business for which discrete financial information is available and where segment management regularly reviews the operating results of that component. The Company aggregates components within an operating segment that have similar economic characteristics. For the annual and, if necessary, interim impairment assessment, the Company identified its reporting units to be its KGS and PSS operating segments.

In order to test for potential impairment, the Company estimates the fair value of each of its reporting units based on a comparison and weighting of the income approach, specifically the discounted cash flow method and the market approach, which estimates the fair value of the Company's reporting units based upon comparable market prices and recent transactions and also validates the reasonableness of the implied multiples from the income approach. The Company reconciles the fair value of its reporting units to its market capitalization by calculating its market capitalization based upon an average of its stock price prior to and subsequent to the date the Company performs its analysis and assuming a control premium. The Company uses these methodologies to determine the fair value of its reporting units for comparison to their corresponding book values because there are no observable inputs available, a Level 3 measurement. If the book value exceeds the estimated fair value for a reporting unit a potential impairment is indicated, and Topic 350 prescribes the approach for determining the impairment amount, if any.

In accordance with Topic 350, as a result of the Company's decision in June 2012 to dispose of certain non-core businesses acquired in the Integral acquisition, the Company allocated $1.5 million of goodwill to discontinued operations, which resulted in an impairment charge (see Note 8). The Company then tested the goodwill remaining in the KGS reporting unit. The fair value of the KGS reporting unit exceeded its carrying value by 7.4% at that time.

During the fourth quarter of 2012, the KGS reporting unit was impacted by continued declining market valuations and the economic uncertainty in the U.S. defense industry. At that time, Congress had been unable to agree on a budget that conformed with the Budget Control Act of 2011 requirements, which required additional substantial defense spending reductions through sequestration. Additionally, Congress and the President failed to agree on budgetary, tax and spending issues, and as a result a FY 2013 budget was not passed and a six-month continuing resolution that funded the U.S. Government through March 27, 2013 was passed. As of December 2012, these events significantly increased the likelihood of the sequester occurring, which had negative consequences for the defense industry. In addition, as Congress and the Administration could not come to an agreement on terms of a possible national fiscal approach, they also failed to address other fiscal matters such as the debt ceiling, which is currently expected to be reached during the third quarter of 2013. These events negatively impacted the Company's estimate of the fair value of the KGS reporting unit, resulting in the book value of KGS exceeding its fair value in step one of the impairment test in the fourth quarter of 2012.

The Company then performed the second step of the goodwill impairment test to measure the amount of the impairment loss, if any, of the KGS reporting unit. The second step of the test requires the allocation of the reporting unit's fair value to its assets and liabilities, including any unrecognized intangible assets, in a hypothetical analysis that calculates the implied fair value of goodwill as if the reporting unit was being acquired in a business combination. If the implied fair value of goodwill is less than the carrying value, the difference is recorded as an impairment loss. Based on the results of the step two analysis, the Company recorded an $82.0 million goodwill impairment in the fourth quarter of 2012. The changes in the carrying amount of goodwill for the six months ended June 30, 2013 are as follows (in millions):

Table of Contents

	Public Safety & Security	Government Solutions	Total
Balance as of December 30, 2012	$35.6	$560.9	$596.5
Retrospective adjustments	—	(0.1)	(0.1)
Balance as of December 30, 2012 after retrospective adjustments	$35.6	$560.8	$596.4

The accumulated impairment losses as of December 30, 2012 and June 30, 2013 were $247.4 million, of which $229.1 million was associated with the KGS segment and $18.3 million was associated with the PSS segment.

Table of Contents

(b) Purchased Intangible Assets

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

	As of December 30, 2012			As of June 30, 2013		
	Gross Value	Accumulated Amortization	Net Value	Gross Value	Accumulated Amortization	Net Value
Acquired finite-lived intangible assets:						
Customer relationships	$97.7	$ (36.2)	$61.5	$97.7	$ (45.1)	$52.6
Contracts and backlog	80.0	(64.3)	15.7	80.0	(71.5)	8.5
Developed technology and technical know-how	22.1	(6.4)	15.7	22.1	(7.5)	14.6
Trade names	6.1	(1.2)	4.9	6.1	(2.2)	3.9
Favorable operating lease	1.8	(0.4)	1.4	1.8	(0.5)	1.3
Total finite-lived intangible assets	207.7	(108.5)	99.2	207.7	(126.8)	80.9
Acquired indefinite-lived intangible assets:						
Trade names	6.9	—	6.9	6.9	—	6.9
Total indefinite-lived intangible assets	6.9	—	6.9	6.9	—	6.9
Total intangible assets	$214.6	$ (108.5)	$106.1	$214.6	$ (126.8)	$87.8

Consolidated amortization expense related to intangible assets subject to amortization was $8.9 million and $9.0 million for the three months ended June 24, 2012 and June 30, 2013, respectively, and $19.4 million and $18.3 million for the six months ended June 24, 2012 and June 30, 2013, respectively.

Note 4. Inventoried Costs

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

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

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

	December 30, 2012	June 30, 2013
Raw materials	$48.4	$42.4
Work in process	36.5	36.5
Finished goods	7.3	5.3
Supplies and other	2.2	1.8
Subtotal inventoried costs	94.4	86.0

Less: Customer advances and progress payments	(0.1)	(0.7)
Total inventoried costs	$94.3	$85.3

13

Table of Contents

Note 5. Stockholders’ Equity

On May 14, 2012, the Company sold 20.0 million shares of its common stock at a purchase price of $5.00 per share in an underwritten public offering. The Company received gross proceeds of $100.0 million. After deducting underwriting and other offering expenses, the Company received approximately $97.0 million in net proceeds. The Company used the net proceeds from this offering to fund a portion of the cash consideration paid to the stockholders of Composite Engineering, Inc. ("CEi") in connection with the Company's acquisition thereof on July 2, 2012.

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

	For the Six Months Ended	
	June 24, 2012	June 30, 2013
Stockholders’ equity at beginning of period	$312.6	$324.1
Comprehensive loss:		
Net loss	(20.2)	(19.9)
Foreign currency translation	(0.2)	0.1
Total comprehensive loss	(20.4)	(19.8)
Additional paid-in-capital from the issuance of common stock for cash	97.0	—
Stock-based compensation	2.3	3.9
Restricted stock units traded for taxes	—	(0.1)
Stockholders’ equity at end of period	$391.5	$308.1

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

	June 24, 2012	June 30, 2013
Cumulative translation adjustment	$(0.1)	$(0.2)
Post retirement benefit reserve adjustment net of tax expense	(0.3)	(0.5)
Total accumulated other comprehensive loss	$(0.4)	$(0.7)

There were no reclassifications from other comprehensive income to net loss for the three or six months ended June 30, 2013.

Common stock issued by the Company for the six months ended June 24, 2012 and June 30, 2013 was as follows (in millions):

	For the Six Months Ended	
	June 24, 2012	June 30, 2013
Shares outstanding at beginning of the period	32.4	56.6
Stock issued for employee stock purchase plan, stock options and restricted stock units exercised	0.1	0.1
Common stock issued for cash	20.0	—
Shares outstanding at end of the period	52.5	56.7

Note 6. Net Income (Loss) Per Common Share

The Company calculates net income (loss) per share in accordance with ASC Topic 260, Earnings Per Share (“Topic 260”). Under Topic 260, basic net income (loss) per common share is calculated by dividing net income (loss) by the weighted-average number of common shares outstanding during the reporting period.

14

Table of Contents

(In millions, except earnings per share)	For the Three Months Ended		For the Six Months Ended	
	June 24, 2012	June 30, 2013	June 24, 2012	June 30, 2013
Loss from continuing operations (A)	$(14.9)	$(7.1)	$(17.4)	$(15.5)
Weighted average outstanding shares of common stock (B)	41.7	56.6	37.1	56.6
Dilutive effect of employee stock options and awards	—	—	—	—
Common stock and common stock equivalents (C)	41.7	56.6	37.1	56.6
Loss per share:				
Basic (A/B)	$(0.36)	$(0.12)	$(0.47)	$(0.27)
Diluted (A/C)	$(0.36)	$(0.12)	$(0.47)	$(0.27)

Note 7. Income Taxes

As of December 30, 2012, the Company had $13.4 million of unrecognized tax benefits that, if recognized, would affect the effective tax rate, subject to possible offset by an increase in the valuation allowance. During the six months ended June 30, 2013, this amount was increased by $0.1 million and was recorded as an adjustment to goodwill. Additionally, the unrecognized tax benefit amount was reduced by $1.5 million relating to the expiration of statutes of limitations. This reduction in unrecognized tax benefits was recorded as a benefit from continuing operations.

The Company recognizes interest and penalties related to unrecognized tax benefits in its provision for income taxes. During the six months ended June 24, 2012, a $0.3 million expense was recorded related to interest and penalties. There was no material expense recorded during the six months ended June 30, 2013. The Company recorded a benefit for interest and penalties related to the reversal of prior positions of $0.1 million and$0.2 million for the six months ended June 24, 2012 and June 30, 2013, respectively. The Company believes that it is reasonably possible that as much as $0.1 million of the liabilities for uncertain tax positions will expire within twelve months of June 30, 2013 due to the expiration of various applicable statutes of limitations.

The Company is subject to taxation in the U.S., various state tax jurisdictions and various foreign tax jurisdictions. The Company's tax years for 2000 and later are subject to examination by the U.S. and state tax authorities due to the existence of net operating loss (“NOL”) carryforwards. Generally, the Company's tax years for 2006 and later are subject to examination by various foreign tax authorities.

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

A reconciliation of the total income tax provision to the amount computed by applying the statutory federal income tax rate of 35% to loss from continuing operations before income tax provision for the three and six months ended June 24, 2012 and June 30, 2013 is as follows (in millions):

15

Table of Contents

	For the Three Months Ended		For the Six Months Ended	
	June 24, 2012	June 30, 2013	June 24, 2012	June 30, 2013
Income tax benefit at federal statutory rate	$(3.1)	$(2.7)	$(5.4)	$(4.5)
State and foreign taxes, net of federal tax benefit and valuation allowance	4.1	0.8	1.1	1.7
Nondeductible expenses and other	0.3	0.2	0.8	0.3
Impact of indefinite lived deferred tax liabilities	2.5	0.8	1.4	2.7
Decrease in reserves for uncertain tax positions	—	(1.7)	(0.1)	(1.6)
Increase in federal valuation allowance	2.8	2.5	4.7	4.1
Total	$6.6	$(0.1)	$2.5	$2.7

Federal and state income tax laws impose restrictions on the utilization of NOL and tax credit carryforwards in the event that an “ownership change” occurs for tax purposes, as defined by Section 382 (“Section 382”) of the Internal Revenue Code of 1986, as amended (the “Code”). In general, an ownership change occurs when shareholders owning 5% or more of a “loss corporation” (a corporation entitled to use NOL or other tax attribute carryovers) have increased their ownership of stock in such corporation by more than 50 percentage points during any 3-year period. The annual base Section 382 limitation is calculated by multiplying the loss corporation's value (which may be modified for certain recent increases to capital) at the time of the ownership change times the greater of the long-term tax-exempt rate determined by the Internal Revenue Service (“IRS”) in the month of the ownership change or the two preceding months. The annual base Section 382 limitation may be increased for certain recognized built-in gains during the five year period succeeding an ownership change. In March 2010, an “ownership change” occurred that will limit the utilization of the loss carryforwards. Additionally, in May 2012, another “ownership change” was triggered. As a result of these changes, the amount of NOLs that can be used in any period are limited. For the three and six months ended June 30, 2013, there was no impact of such limitations on the income tax provision since the amount of taxable income did not exceed the annual limitation amount. In addition, future equity offerings or acquisitions that have equity as a component of the purchase price could also result in an ownership change. If and when any other “ownership change” occurs, utilization of the NOL or other tax attributes may be further limited. As discussed elsewhere, deferred tax assets relating to the NOL and credit carryforwards are offset by a full valuation allowance.

Note 8. Discontinued Operations

In June 2012, consistent with the Company's plans to complete its assessment and evaluation of the non-core businesses acquired in the Integral acquisition, the Company committed to a plan to sell certain lines of business associated with antennas, satellite-cased products and fly-away terminals. These operations were previously reported in the KGS segment, and in accordance with Topic 205, Presentation of Financial Statements ("Topic 205"), these businesses have been classified as held for sale and reported in discontinued operations in the accompanying condensed consolidated financial statements. In the second quarter of 2012, the Company recorded a $1.5 million impairment charge associated with the portion of goodwill that was allocated to the discontinued businesses based on management's estimate of the fair value of the business. The Company sold its domestic operations to two buyers for approximately $0.8 million in cash consideration and the assumption of certain liabilities. The Company received $0.3 million in cash in 2012 from the first buyer and $0.5 million in cash in April 2013 from the second buyer. The Company recorded a $1.2 million impairment charge in the first quarter of 2013 related to its revised estimate of the fair value of these operations.

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

	For the Three Months Ended		For the Six Months Ended	
	June 24, 2012	June 30, 2013	June 24, 2012	June 30, 2013

Revenue	$1.8	$0.5	$7.4	$3.6
Net loss before taxes	(2.3)	(2.5)	(2.9)	(4.4)
Provision for income taxes	—	—	(0.1)	—
Net loss after taxes	$(2.3)	$(2.5)	$(2.8)	$(4.4)

16

Table of Contents

The following is a summary of the assets and liabilities of discontinued operations, which are in other current assets, other non-current assets, other current liabilities and other long-term liabilities in the accompanying condensed consolidated balance sheets as of December 30, 2012 and June 30, 2013 (in millions):

	December 30, 2012	June 30, 2013
Accounts receivable, net	$3.4	$0.4
Inventoried costs	3.0	—
Other current assets	0.2	0.2
Current assets of discontinued operations	6.6	0.6
Property and equipment, net	0.4	$—
Other non-current assets	0.4	—
Non-current assets of discontinued operations	$0.8	$—
Accounts payable and accrued expenses	$4.4	$3.4
Billings in excess of costs and earnings on uncompleted contracts	0.1	—
Other current liabilities	0.4	0.3
Current liabilities of discontinued operations	4.9	3.7
Other long-term liabilities	0.3	—
Non-current unrecognized tax liabilities	$—	$0.1
Long-term liabilities of discontinued operations	$0.3	$0.1

Note 9. Debt

(a) Issuance of 10% Senior Secured Notes due 2017

On May 19, 2010, the Company entered into an indenture with the guarantors set forth therein and Wilmington Trust FSB, as trustee and collateral agent (as amended or supplemented the “Indenture”), to issue the Notes. As of June 30, 2013, the Company has issued Notes in the aggregate principal amount of $625.0 million under the Indenture, of which $225.0 million were issued on May 19, 2010, $285.0 million were issued on March 25, 2011 at a $20.0 million premium and an effective interest rate of 8.5%, and $115.0 million were issued on July 27, 2011 at a $5.8 million premium and an effective interest rate of 8.9%. These Notes have been used to fund acquisitions and for general corporate purposes. The holders of the Notes have a first priority lien on substantially all of the Company's assets and the assets of the guarantors, except with respect to accounts receivable, inventory, deposit accounts, securities accounts, cash, securities and general intangibles (other than intellectual property), on which the holders of the Notes have a second priority lien to the $110.0 million credit facility described below.

The Company pays interest on the Notes semi-annually, in arrears, on June 1 and December 1 of each year. The Notes include customary covenants and events of default as well as a consolidated fixed charge ratio of 2:1 for the incurrence of additional indebtedness. Negative covenants include, among other things, limitations on additional debt, liens, negative pledges, investments, dividends, stock repurchases, asset sales and affiliate transactions. Events of default include, among other events, non-performance of covenants, breach of representations, cross-default to other material debt, bankruptcy, insolvency, material judgments and changes in control. As of June 30, 2013, the Company was in compliance with the covenants contained in the Indenture governing the Notes.

On or after June 1, 2014, the Company may redeem some or all of the Notes at 105% of the aggregate principal amount of such notes through June 1, 2015, 102.5% of the aggregate principal amount of such notes through June 1, 2016 and 100% of the aggregate principal amount of such notes thereafter, plus accrued and unpaid interest to the date of redemption. Prior to June 1, 2013, the Company may have redeemed up to 35% of the aggregate principal amount of the Notes at 110% of the aggregate principal amount of the Notes, plus accrued and unpaid interest to the date of redemption, with the net cash proceeds of certain equity offerings. In addition, the Company may, at its option, redeem some or all of the Notes at any time prior to June 1, 2014 by paying a “make whole” premium, plus accrued and unpaid interest, if any, to the date of redemption. The Company may also purchase outstanding Notes traded on the open market at any time.

(b) Other Indebtedness

$110.0 Million Credit Facility

Table of Contents

On July 27, 2011, the Company entered into a credit and security agreement with KeyBank National Association (“KeyBank”), as lead arranger, sole book runner and administrative agent, and East West Bank and Bank of the West, as the lenders (the “2011 Credit Agreement”). The 2011 Credit Agreement amends and restates in its entirety the credit and security agreement, dated as of May 19, 2010, by and among the Company, KeyBank and the lenders named therein (as amended). The 2011 Credit Agreement established a five-year senior secured revolving credit facility in the amount of $65.0 million (as amended and described below, the “Amended Revolver”). The Amended Revolver is secured by a lien on substantially all of the Company's assets and the assets of the guarantors thereunder, subject to certain exceptions and permitted liens. The Amended Revolver has a first priority lien on accounts receivable, inventory, deposit accounts, securities accounts, cash, securities and general intangibles (other than intellectual property). On all other assets, the Amended Revolver has a second priority lien junior to the lien securing the Notes.

Borrowings under the Amended Revolver are subject to mandatory prepayment upon the occurrence of certain events, including the issuance of certain securities, the incurrence of certain debt and the sale or other disposition of certain assets. The Amended Revolver includes customary affirmative and negative covenants and events of default, as well as a financial covenant relating to a minimum fixed charge coverage ratio of 1.25. Negative covenants include, among other things, limitations on additional debt, liens, negative pledges, investments, dividends, stock repurchases, asset sales and affiliate transactions. Events of default include, among other events, non-performance of covenants, breach of representations, cross-default to other material debt, bankruptcy and insolvency, material judgments and changes in control.

On November 14, 2011, the Company entered into a first amendment (the “First Amendment”) with certain lenders and KeyBank that amended the 2011 Credit Agreement. Among other things, the First Amendment: (i) increased the amount of the Amended Revolver from $65.0 million to $90.0 million; (ii) added to and modified the definitions of certain terms contained in the 2011 Credit Agreement; (iii) added PNC Bank, National Association as a lender under the 2011 Credit Agreement; and (iv) updated certain schedules to the 2011 Credit Agreement.

On May 4, 2012, the Company entered into a second amendment (the "Second Amendment") to the 2011 Credit Agreement. Among other things, the Second Amendment (i) increased the amount of the Amended Revolver from $90.0 million to $110.0 million, (ii) added to and modified the definitions of certain terms contained in the 2011 Credit Agreement, (iii) added Cathay Bank as a lender under the 2011 Credit Agreement, (iv) increased the maximum available to be borrowed under the 2011 Credit Agreement to $135.0 million subject to KeyBank's approval, and (v) updated certain schedules to the Credit Agreement.

On May 8, 2012, the Company entered into a third amendment (the "Third Amendment") to the 2011 Credit Agreement. Under the terms of the Third Amendment, the definitions of certain terms of the 2011 Credit Agreement were modified and the acquisition of CEi was approved. The Company used the net proceeds from the sale of 20.0 million shares of its common stock, together with the borrowings under its credit facility, to fund the purchase of CEi on July 2, 2012 and to pay related fees and expenses.

On February 27, 2013, the Company entered into a fourth amendment (the "Fourth Amendment") to the 2011 Credit Agreement. Under the terms of the Fourth Amendment, the definition of certain terms of the 2011 Credit Agreement and reporting requirements were modified.

The amounts of borrowings that may be made under the Amended Revolver are based on a borrowing base and are comprised of specified percentages of eligible receivables, eligible unbilled receivables and eligible inventory. If the amount of borrowings outstanding under the Amended Revolver exceeds the borrowing base then in effect, the Company is required to repay such borrowings in an amount sufficient to eliminate such excess. The Amended Revolver includes $50.0 million of availability for letters of credit and $10.0 million of availability for swing line loans.

The Company may borrow funds under the Amended Revolver at a rate based either on LIBOR or a base rate established by KeyBank. Base rate borrowings bear interest at an applicable margin of 1.00% to 1.75% over the base rate (which will be the greater of the prime rate or 0.5% over the federal funds rate, with a floor of 1.0% over one month LIBOR). LIBOR rate borrowings will bear interest at an applicable margin of 3.00% to 3.75% over the LIBOR rate. The applicable margin for base rate borrowings and LIBOR borrowings will depend on the average monthly revolving credit availability. The Amended Revolver also has a commitment fee of 0.50% to 0.75%, depending on the average monthly revolving credit availability. As of June 30, 2013, there were no outstanding borrowings on the Amended Revolver and $14.2 million was outstanding on letters of credit, resulting in net borrowing base availability of $69.3 million. The Company was in compliance with the financial covenants as of June 30, 2013.

Debt Acquired in Acquisition of Herley

Table of Contents

The Company assumed a $10.0 million 10-year term loan with a bank in Israel that Herley entered into on September 16, 2008 in connection with the acquisition of one of its wholly owned subsidiaries. The balance as of June 30, 2013 was $5.3 million, and the loan is payable in quarterly installments of $0.3 million plus interest at LIBOR plus a margin of 1.5%. The loan agreement contains various covenants, including a minimum net equity covenant as defined in the loan agreement. The Company was in compliance with all covenants, including the minimum net equity covenant, as of June 30, 2013.

Fair Value of Long-term Debt

Carrying amounts and the related estimated fair values of the Company's long-term debt financial instruments not measured at fair value on a recurring basis at December 30, 2012 and June 30, 2013 are presented in the following table:

	As of December 30, 2012			As of June 30, 2013		
$ in millions	Principal	Carrying Amount	Fair Value	Principal	Carrying Amount	Fair Value
Total Long-term debt including current portion	$630.7	$649.4	$690.5	$630.3	$646.9	$676.2

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

The net unamortized debt premium of $16.6 million as of June 30, 2013, which is the difference between the carrying amount of $646.9 million and the principal amount of $630.3 million represented in the previous table, is being amortized to interest expense over the terms of the related debt.

Note 10. Fair Value of Financial Instruments

The carrying amounts and the related estimated fair values of the Company's long-term debt financial instruments not measured at fair value on a recurring basis at December 30, 2012 and June 30, 2013 are presented in Note 9. The carrying value of all other financial instruments, including cash equivalents, accounts receivable, accounts payable and short-term debt, approximated their estimated fair values at December 30, 2012 and June 30, 2013.

Note 11. Significant Customers

Revenue from the U.S. Government, which includes foreign military sales, includes revenue from contracts for which the Company is the prime contractor as well as those for which the Company is a subcontractor and the ultimate customer is the U.S. Government. The KGS segment has substantial revenue from the U.S. Government. Sales to the U.S. Government amounted to approximately $140.0 million and $152.2 million or 64% and 65% of total Kratos revenue for the three months ended June 24, 2012 and June 30, 2013, respectively, and approximately $280.9 million and $317.6 million, or 65% and 65%, of total revenue for the six months ended June 24, 2012 and June 30, 2013, respectively.

The U.S. Government continues to focus on developing and implementing spending, tax, and other initiatives to reduce the deficit, create jobs, and stimulate the economy. Although defense spending is expected to remain a national priority within future federal budgets, the Budget Control Act of 2011 ("Budget Control Act") committed the U.S.

Government to reduce the federal deficit over the following ten years. Under the Budget Control Act, the Bi-Partisan Congressional Joint Select Committee on Deficit Reduction (“the Joint Committee”) was responsible for identifying $1.2 to $1.5 trillion in deficit reductions by November 30, 2011. The Joint Committee was unable to identify the reductions by this deadline and thereby triggered a provision of the Budget Control Act called “sequestration,” which requires very substantial automatic spending cuts that have started in 2013, are split between defense and non-defense programs, and continue over a nine-year period.

On March 26, 2013, the President signed into law the Consolidated and Further Continuing Appropriations Act, 2013, which includes specific appropriations for the Company's major federal customers, including the DoD. On April 10, 2013, the President delivered his proposed FY 2014 budget to Congress. The President's $527 billion FY 2014 defense budget is slightly lower than final defense appropriations for FY 2013. While it largely reflects defense spending plans in the FY 2013 budget, it does not reflect the reductions mandated by Part II of the Budget Control Act. The Congressional appropriation and

Table of Contents

authorization of FY 2014 defense spending is likely to be marked by significant debate and an uncertain schedule. There continues to be uncertainty in how sequestration will ultimately be implemented, and there are many variables in how the law could be applied that make it difficult to determine the specific impacts. Any automatic reductions in national defense programs could impact the Company's significant customers, which in turn could impact the Company's business and financial results.

Note 12. Segment Information

The Company operates in two principal business segments: Kratos Government Solutions and Public Safety & Security. The Company organizes its business segments based on the nature of the services offered. In the following table, total operating income of the business segments is reconciled to the corresponding consolidated amount. The reconciling item “Unallocated corporate expense, net” includes costs for certain stock-based compensation programs (including stock-based compensation costs for stock options, employee stock purchase plan shares and restricted stock units), the effects of items not considered part of management’s evaluation of segment operating performance, merger and acquisition expenses, corporate costs not allocated to the operating segments, and other miscellaneous corporate activities. Transactions between segments are generally negotiated and accounted for under terms and conditions similar to other government and commercial contracts.

Revenues, depreciation and amortization, and operating income generated by the Company’s current reporting segments for the three and six month periods ended June 24, 2012 and June 30, 2013 are as follows (in millions):

	Three Months Ended		Six Months Ended	
	June 24, 2012	June 30, 2013	June 24, 2012	June 30, 2013
Revenues:				
Kratos Government Solutions				
Service revenues	$68.1	$58.5	$129.6	$123.9
Product sales	107.7	125.0	215.1	262.3
Total Kratos Government Solutions	175.8	183.5	344.7	386.2
Public Safety & Security				
Service revenues	44.0	51.7	84.6	102.3
Product sales	—	—	—	—
Total Public Safety & Security	44.0	51.7	84.6	102.3
Total revenues	$219.8	$235.2	$429.3	$488.5
Depreciation & amortization:				
Kratos Government Solutions	11.4	$12.7	$24.2	$25.9
Public Safety & Security	0.9	0.9	1.7	1.9
Total depreciation and amortization	$12.3	$13.6	$25.9	$27.8
Operating income:				
Kratos Government Solutions	$8.8	$5.3	$18.4	$17.4
Public Safety & Security	2.8	2.7	4.0	3.9
Unallocated corporate expense, net	(4.2)	0.9	(5.9)	(1.0)
Total operating income	$7.4	$8.9	$16.5	$20.3

Note 13. Commitments and Contingencies

(a) Legal Matters

In addition to commitments and obligations in the ordinary course of business, the Company is subject to various claims, pending and potential legal actions for damages, investigations relating to governmental laws and regulations and other matters arising out of the normal conduct of its business. The Company assesses contingencies to determine the degree of probability and range of possible loss for potential accrual in its consolidated financial statements. An estimated loss contingency is accrued in the Company's consolidated financial statements if it is probable that a liability has been incurred and the amount of the loss can be reasonably estimated. Because litigation is inherently unpredictable and unfavorable resolutions could occur, assessing litigation contingencies is highly subjective and requires judgments about future events. When evaluating contingencies, the Company may be unable to provide a meaningful estimate due to a number of factors, including the procedural status of the matter in question, the presence of complex or novel legal theories, and/or the ongoing discovery

20

Table of Contents

and development of information important to the matters. In addition, damage amounts claimed in litigation against the Company may be unsupported, exaggerated or unrelated to possible outcomes, and as such are not meaningful indicators of the Company's potential liability. The Company regularly reviews contingencies to determine the adequacy of its accruals and related disclosures. The amount of ultimate loss may differ from these estimates. It is possible that cash flows or results of operations could be materially affected in any particular period by the unfavorable resolution of one or more of these contingencies. Whether any losses finally determined in any claim, action, investigation or proceeding could reasonably have a material effect on the Company's business, financial condition, results of operations or cash flows will depend on a number of variables, including the timing and amount of such losses; the structure and type of any remedies; the monetary significance of any such losses, damages or remedies on the Company's consolidated financial statements; and the unique facts and circumstances of the particular matter that may give rise to additional factors.

Legal and Regulatory Matters

Integral Indemnification Obligation. Integral, which was acquired on July 27, 2011, was previously the subject of a SEC investigation. On July 30, 2009, the SEC and Integral each announced that an administrative settlement had been reached concluding the SEC's investigation. In conjunction with its announcement of the administrative settlement, the SEC disclosed that it was instituting separate civil actions against three former officers of Integral, Steven R. Chamberlain (now deceased), Elaine M. Brown and Gary A. Prince, in a case filed July 30, 2009 captioned United States Securities and Exchange Commission v. Steven R. Chamberlain, Elaine M. Brown, and Gary A. Prince, Case No. 09-CV-01423, pending in the United States District Court for the District of Columbia. The SEC's complaint alleges that from 1999 through August 2006, Chamberlain, Brown and Prince made materially false and misleading statements and omitted material information in various filings with the SEC by failing to disclose the role of Prince, who had been convicted of engaging in securities fraud while at another company, at Integral and his legal background in its filings. The SEC sought permanent injunctions against each defendant, as well as court orders imposing officer and director bars and civil penalties. Integral has indemnification obligations to these individuals, as well as to other former directors and officers of Integral who may incur indemnifiable costs in connection with these actions, pursuant to the terms of separate indemnification agreements entered into with each of them effective as of December 4, 2002. As a result of the acquisition of Integral, the Company has assumed these indemnification obligations. The indemnification agreements provide, subject to certain terms and conditions, that the Company shall indemnify the individual to the fullest extent permissible by Maryland law against judgments, penalties, fines, settlements and reasonable expenses actually incurred in the event that the individual is made a party to a legal proceeding by reason of his or her present or prior service as an officer or employee of Integral, and shall also advance reasonable litigation expenses actually incurred subject to, among other conditions, receipt of a written undertaking to repay any costs or expenses advanced if it shall ultimately be determined that the individual has not met the standard of conduct required for indemnification under Maryland law. Certain costs and expenses were previously covered under Integral's applicable directors and officers liability insurance policy. The policy limits were exhausted in December 2011, and the Company is advancing payment of indemnifiable costs pursuant to the indemnification agreements. On November 26, 2012, the SEC announced that it had finalized a settlement with Elaine M. Brown, resulting in a final judgment that resolved the SEC's matter against Brown. The SEC's case against Gary A. Prince proceeded to a bench trial in December 2012, which trial concluded in January 2013. On May 2, 2013, the court issued a memorandum opinion and entered an order granting judgment in favor of the SEC on one count of its complaint. The court found that in 1997, an accounting bar order had been issued against Mr. Prince because of his conduct at a different company, and that Mr. Prince violated the bar order between 1998 and 2006. The court issued an injunction permanently restraining and enjoining Mr. Prince from violating the accounting bar order. The court entered judgment in favor of Mr. Prince on all other counts of the SEC's complaint. No relief was sought or entered against Integral. The deadline for appeals expired on July 1, 2013. Neither party appealed, so the trial court's judgment is final. This matter is now concluded.

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

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

(b) Warranty

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

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

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

	Six Months Ended	
	June 24, 2012	June 30, 2013
Balance at beginning of the period	$4.3	$5.3
Costs accrued and revenues deferred	0.6	(0.1)
Warranty liabilities assumed from acquisitions	0.5	(0.2)
Settlements made (in cash or kind) and revenues recognized	(0.8)	—
Balance at end of period	4.6	5.0
Less: Current portion	4.6	4.6
Non-current accrued product warranty and deferred warranty revenue	$—	$0.4

Note 14. Condensed Consolidating Financial Statements

The Company has $625.0 million in outstanding Senior Secured Notes (see Note 9). The Notes are guaranteed by all of the Company's 100% owned domestic subsidiaries (the "Subsidiary Guarantors") and are collateralized by the assets of all of the Company's 100% owned subsidiaries. The Notes are fully and unconditionally guaranteed on a joint and several basis by each guarantor subsidiary and the Company. There are no contractual restrictions limiting cash transfers from guarantor subsidiaries by dividends, loans or advances to the Company. The Senior Secured Notes are not guaranteed by the Company's foreign subsidiaries (the “Non-Guarantor Subsidiaries”).

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

Table of Contents

Condensed Consolidating Balance Sheet
December 30, 2012
(Unaudited)

	Parent Company	Guarantors on a Combined Basis	Non-Guarantors on a Combined Basis	Eliminations	Consolidated
Assets					
Current Assets:					
Cash and cash equivalents	$37.8	$(4.0)	$ 15.2	$—	$49.0
Accounts receivable, net	—	253.5	18.4	—	271.9
Amounts due from affiliated companies	480.2	—	—	(480.2)	—
Inventoried costs	—	75.4	18.9	—	94.3
Other current assets	9.1	28.0	3.1	—	40.2
Total current assets	527.1	352.9	55.6	(480.2)	455.4
Property, plant and equipment, net	1.3	74.7	9.6	—	85.6
Goodwill	—	574.7	21.7	—	596.4
Intangible assets, net	—	103.4	2.7	—	106.1
Investment in subsidiaries	439.8	28.8	—	(468.6)	—
Amounts due from affiliated companies	—	24.0	—	(24.0)	—
Other assets	17.6	22.4	0.4	—	40.4
Total assets	$985.8	$1,180.9	$ 90.0	$(972.8)	$1,283.9
Liabilities and Stockholders' Equity					
Current liabilities:					
Accounts payable	$2.8	$75.2	$ 5.6	$—	$83.6
Accrued expenses	7.0	42.3	3.4	—	52.7
Accrued compensation	2.9	41.8	3.1	—	47.8
Billings in excess of costs and earnings on uncompleted contracts	—	40.5	3.2	—	43.7
Deferred income tax liability	—	28.9	—	—	28.9
Amounts due to affiliated companies	—	455.1	25.1	(480.2)	—
Other current liabilities	1.1	19.1	1.9	—	22.1
Total current liabilities	13.8	702.9	42.3	(480.2)	278.8
Long-term debt, net of current portion	643.6		4.8	—	648.4
Amounts due to affiliated companies	—	—	24.0	(24.0)	—
Other long-term liabilities	4.3	26.2	2.1	—	32.6
Total liabilities	661.7	729.1	73.2	(504.2)	959.8
Total stockholders' equity	324.1	451.8	16.8	(468.6)	324.1
Total liabilities and stockholders' equity	$985.8	$1,180.9	$ 90.0	$(972.8)	$1,283.9

Table of Contents

Condensed Consolidating Balance Sheet
June 30, 2013
(Unaudited)

	Parent Company	Guarantors on a Combined Basis	Non-Guarantors on a Combined Basis	Eliminations	Consolidated
Assets					
Current Assets:					
Cash and cash equivalents	$32.0	$(3.5)	$ 21.2	$—	$49.7
Accounts receivable, net	—	237.0	16.6	—	253.6
Amounts due from affiliated companies	451.9	—	—	(451.9)	—
Inventoried costs	—	69.0	16.3	—	85.3
Other current assets	10.9	15.4	2.9	—	29.2
Total current assets	494.8	317.9	57.0	(451.9)	417.8
Amounts due from affiliated companies, long-term	—	24.0	—	(24.0)	—
Property, plant and equipment, net	1.7	71.8	10.0	—	83.5
Goodwill	—	574.7	21.7	—	596.4
Intangible assets, net	—	85.8	2.0	—	87.8
Investment in subsidiaries	456.2	32.1	—	(488.3)	—
Other assets	15.1	21.5	0.2	—	36.8
Total assets	$967.8	$1,127.8	$ 90.9	$(964.2)	$1,222.3
Liabilities and Stockholders' Equity					
Current liabilities:					
Accounts payable	$4.1	$57.0	$ 3.8	$—	$64.9
Accrued expenses	7.2	35.4	2.6	—	45.2
Accrued compensation	3.3	33.8	2.7	—	39.8
Billings in excess of costs and earnings on uncompleted contracts	—	38.4	7.2	—	45.6
Deferred income tax liability	—	29.0	—	—	29.0
Amounts due to affiliated companies	—	429.2	22.7	(451.9)	—
Other current liabilities	0.9	12.0	1.2	—	14.1
Total current liabilities	15.5	634.8	40.2	(451.9)	238.6
Long-term debt, net of current portion	641.6	—	4.3	—	645.9
Amounts due to affiliated companies	—	—	24.0	(24.0)	—
Other long-term liabilities	2.6	24.8	2.3	—	29.7
Total liabilities	659.7	659.6	70.8	(475.9)	914.2
Total stockholders' equity	308.1	468.2	20.1	(488.3)	308.1
Total liabilities and stockholders' equity	$967.8	$1,127.8	$ 90.9	$(964.2)	$1,222.3

Table of Contents

Condensed Consolidating Statement of Operations and Comprehensive Income (Loss)
Three Months Ended June 24, 2012
(Unaudited)

	Parent Company	Guarantors on a Combined Basis	Non-Guarantors on a Combined Basis	Eliminations	Consolidated
Service revenues	$—	$111.5	$ 0.6	$—	$112.1
Product sales	—	96.6	14.7	(3.6)	107.7
Total revenues	—	208.1	15.3	(3.6)	219.8
Cost of service revenues	—	86.2	0.5	—	86.7
Cost of product sales	—	69.2	9.8	(3.6)	75.4
Total costs	—	155.4	10.3	(3.6)	162.1
Gross profit	—	52.7	5.0	—	57.7
Selling, general and administrative expenses	2.6	40.0	2.9	—	45.5
Research and development expenses	—	4.6	0.2	—	4.8
Operating income from continuing operations	(2.6)	8.1	1.9	—	7.4
Other income (expense):					
Interest expense, net	(16.1)	0.1	(0.2)	—	(16.2)
Other income (expense), net	—	0.2	0.3	—	0.5
Total other income and expense, net	(16.1)	0.3	0.1	—	(15.7)
Income (loss) from continuing operations before income taxes	(18.7)	8.4	2.0	—	(8.3)
Provision for income taxes from continuing operations	—	5.7	0.9	—	6.6
Income (loss) from continuing operations	(18.7)	14.1	2.9	—	(14.9)
Income (loss) from discontinued operations	—	(2.2)	(0.1)	—	(2.3)
Equity in net income (loss) of subsidiaries	1.5	1.0	—	(2.5)	—
Net income (loss)	$(17.2)	$12.9	$ 2.8	$(2.5)	$(17.2)
Comprehensive income (loss)	$(17.4)	$1.7	$ 1.1	$(2.8)	$(17.4)

Table of Contents

Condensed Consolidating Statement of Operations and Comprehensive Income (Loss)
Three Months Ended June 30, 2013
(Unaudited)

	Parent Company	Guarantors on a Combined Basis	Non-Guarantors on a Combined Basis	Eliminations	Consolidated
Service revenues	$—	$109.3	$ 0.9	$—	$110.2
Product sales	—	110.9	18.8	(4.7)	125.0
Total revenues	—	220.2	19.7	(4.7)	235.2
Cost of service revenues	—	82.6	0.7	—	83.3
Cost of product sales	—	82.8	13.4	(4.7)	91.5
Total costs	—	165.4	14.1	(4.7)	174.8
Gross profit	—	54.8	5.6	—	60.4
Selling, general and administrative expenses	1.1	42.4	3.2	—	46.7
Research and development expenses	—	4.5	0.3	—	4.8
Operating income from continuing operations	(1.1)	7.9	2.1	—	8.9
Other income (expense):					
Interest expense, net	(16.1)	—	(0.2)	—	(16.3)
Other income (expense), net	—	0.1	0.1	—	0.2
Total other income and expense, net	(16.1)	0.1	(0.1)	—	(16.1)
Income (loss) from continuing operations before income taxes	(17.2)	8.0	2.0	—	(7.2)
Benefit for income taxes from continuing operations	0.2	(0.4)	0.1	—	(0.1)
Income (loss) from continuing operations	(17.4)	8.4	1.9	—	(7.1)
Income (loss) from discontinued operations	0.1	(2.7)	0.1	—	(2.5)
Equity in net income (loss) of subsidiaries	7.7	2.0	—	(9.7)	—
Net income (loss)	$(9.6)	$7.7	$ 2.0	$(9.7)	$(9.6)
Comprehensive income (loss)	$(9.6)	$7.7	$ 2.0	$(9.7)	$(9.6)

Table of Contents

Condensed Consolidating Statement of Operations and Comprehensive Income (Loss)
Six Months Ended June 24, 2012
(Unaudited)

	Parent Company	Guarantors on a Combined Basis	Non-Guarantors on a Combined Basis	Eliminations	Consolidated
Service revenues	$—	$213.0	$ 1.2	$—	$214.2
Product sales	—	192.6	29.0	(6.5)	215.1
Total revenues	—	405.6	30.2	(6.5)	429.3
Cost of service revenues	—	165.7	0.8	—	166.5
Cost of product sales	—	134.9	19.3	(6.5)	147.7
Total costs	—	300.6	20.1	(6.5)	314.2
Gross profit	—	105.0	10.1	—	115.1
Selling, general and administrative expenses	4.8	78.9	6.5	—	90.2
Research and development expenses	—	7.9	0.5	—	8.4
Operating income from continuing operations	(4.8)	18.2	3.1	—	16.5
Other income expense:					
Interest expense, net	(32.1)	0.1	(0.3)	—	(32.3)
Other expense, net	0.3	0.1	0.5	—	0.9
Total other expense, net	(31.8)	0.2	0.2	—	(31.4)
Income (loss) from continuing operations before income taxes	(36.6)	18.4	3.3	—	(14.9)
Provision for income taxes from continuing operations	—	2.3	0.2	—	2.5
Income (loss) from continuing operations	(36.6)	16.1	3.1	—	(17.4)
Loss from discontinued operations	—	(2.8)	—	—	(2.8)
Equity in net income (loss) of subsidiaries	16.4	3.0	—	(19.4)	—
Net income (loss)	(20.2)	16.3	3.1	(19.4)	(20.2)
Comprehensive income (loss)	$(20.4)	$16.3	$ 3.2	$(19.5)	$(20.4)

27

Table of Contents

Condensed Consolidating Statement of Operations and Comprehensive Income (Loss)
Six Months Ended June 30, 2013
(Unaudited)

	Parent Company	Guarantors on a Combined Basis	Non-Guarantors on a Combined Basis	Eliminations	Consolidated
Service revenues	$—	$224.8	$ 1.4	$—	$226.2
Product sales	—	234.2	37.6	(9.5)	262.3
Total revenues	—	459.0	39.0	(9.5)	488.5
Cost of service revenues	—	170.8	1.1	—	171.9
Cost of product sales	—	173.5	26.4	(9.5)	190.4
Total costs	—	344.3	27.5	(9.5)	362.3
Gross profit	—	114.7	11.5	—	126.2
Selling, general and administrative expenses	3.7	86.2	6.3	—	96.2
Research and development expenses	—	9.0	0.7	—	9.7
Operating income from continuing operations	(3.7)	19.5	4.5	—	20.3
Other income expense:					
Interest expense, net	(32.2)	—	(0.3)	—	(32.5)
Other expense, net	—	0.1	(0.7)	—	(0.6)
Total other expense, net	(32.2)	0.1	(1.0)	—	(33.1)
Income (loss) from continuing operations before income taxes	(35.9)	19.6	3.5	—	(12.8)
Provision for income taxes from continuing operations	0.5	2.0	0.2	—	2.7
Income (loss) from continuing operations	(36.4)	17.6	3.3	—	(15.5)
Loss from discontinued operations	0.1	(4.5)	—	—	(4.4)
Equity in net income (loss) of subsidiaries	16.4	3.3	—	(19.7)	—
Net income (loss)	$(19.9)	$16.4	$ 3.3	$(19.7)	$(19.9)
Comprehensive income (loss)	$(19.8)	$16.4	$ 3.2	$(19.6)	$(19.8)

Condensed Consolidating Statement of Cash Flows
Six Months Ended June 24, 2012
(Unaudited)

	Parent Company	Guarantors on a Combined Basis	Non-Guarantors on a Combined Basis	Eliminations	Consolidated
Net cash provided by (used in) operating activities	$(40.5)	$43.2	$ 7.1	$—	$9.8
Investing activities:					
Cash paid for acquisitions, net of cash acquired	(21.5)	—	—	—	(21.5)
(Increase) decrease in restricted cash	(0.4)	0.7	—	—	0.3
Capital expenditures	—	(5.1)	(1.1)	—	(6.2)
Net cash used in investing activities from continuing operations	(21.9)	(4.4)	(1.1)	—	(27.4)
Financing activities:					
Proceeds from the issuance of common stock for cash, net of issuance costs	97.0	—	—	—	97.0
Cash paid for contingent acquisition consideration	(2.5)	—	—	—	(2.5)
Debt issuance costs	(1.0)	—	—	—	(1.0)
Repayment of debt	—	—	(0.5)	—	(0.5)
Financing from affiliated companies	43.0	(43.0)	—	—	—
Other, net	—	(0.3)	—	—	(0.3)
Net cash provided by (used in) financing activities from continuing operations	136.5	(43.3)	(0.5)	—	92.7
Net cash flows of continuing operations	74.1	(4.5)	5.5	—	75.1
Net operating cash flows from discontinued operations	—	1.3	—	—	1.3
Effect of exchange rate changes on cash and cash equivalents	—	—	(0.3)	—	(0.3)
Net increase in cash and cash equivalents	$74.1	$(3.2)	$ 5.2	$—	$76.1

Table of Contents

Condensed Consolidating Statement of Cash Flows
Six Months Ended June 30, 2013
(Unaudited)

	Parent Company	Guarantors on a Combined Basis	Non-Guarantors on a Combined Basis	Eliminations	Consolidated
Net cash provided by (used in) operating activities	$(33.4)	$36.1	$ 5.7	$—	$8.4
Investing activities:					
Cash paid for acquisitions, net of cash acquired	—	1.2	—	—	1.2
Decrease in restricted cash	—	0.2	—	—	0.2
Other, net	—	0.4	—	—	0.4
Capital expenditures	(0.7)	(5.5)	(1.1)	—	(7.3)
Net cash used in investing activities from continuing operations	(0.7)	(3.7)	(1.1)	—	(5.5)
Financing activities:					
Repayment of debt	—	—	(0.5)	—	(0.5)
Cash paid for contingent acquisition consideration	—	(2.1)	—	—	(2.1)
Financings from affiliated companies	28.6	(30.7)	2.1	—	—
Other, net	(0.3)	—	—	—	(0.3)
Net cash provided by (used in) financing activities from continuing operations	28.3	(32.8)	1.6	—	(2.9)
Net cash flows of continuing operations	(5.8)	(0.4)	6.2	—	—
Net operating cash flows from discontinued operations	—	0.8	—	—	0.8
Effect of exchange rate changes on cash and cash equivalents	—	—	(0.1)	—	(0.1)
Net increase (decrease) in cash and cash equivalents	$(5.8)	$0.4	$ 6.1	$—	$0.7

30

Table of Contents

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

This Quarterly Report on Form 10-Q (this "Quarterly Report") contains "forward-looking statements" relating to our future financial performance, the market for our services and our expansion plans and opportunities. In some cases, you can identify forward-looking statements by terminology such as "may," "will," "should," "expect," "plan," "anticipate," "believe," "estimate," "predict," "potential," or "continue," the negative of such terms or other comparable terminology. These forward-looking statements reflect our current beliefs, expectations and projections, are based on assumptions, and are subject to known and unknown risks and uncertainties that could cause our actual results or achievements to differ materially from any future results or achievements expressed in or implied by our forward-looking statements. Many of these factors are beyond our ability to control or predict. As a result, you should not place undue reliance on forward-looking statements. The most important risk and uncertainties that could cause our actual results or achievements to differ materially from the results or achievements reflected in our forward-looking statements, include, but are not limited to: changes or cutbacks in spending or the appropriation of funding by the federal government, including the U.S. Department of Defense, which could cause delays, cancellations or reductions of key government contracts; changes in the scope or timing of our projects; the timing, rescheduling or cancellation of significant customer contracts and agreements, or consolidation by or the loss of key customers; risks of adverse regulatory action or litigation; risks associated with debt leverage; failure to successfully consummate acquisitions or integrate acquired operations; risks related to security breaches, cybersecurity attacks or other significant disruptions of our information systems; and competition in the marketplace, which could reduce revenues and profit margins, as well as the additional risks and uncertainties described in this Quarterly Report on Form 10-Q and in "Item 1A-Risk Factors" of our Annual Report on Form 10-K for the fiscal year ended December 30, 2012 filed with the Securities and Exchange Commission on March 12, 2013. These forward-looking statements reflect our views and assumptions only as of the date such forward-looking statements are made. Except as required by law, we assume no responsibility for updating any forward-looking statements, whether as a result of new information, future events or otherwise.

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

Overview

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

We manufacture and design specialized electronic components, subsystems and systems for electronic attack, electronic warfare, radar, intelligence,surveillance and reconnaissance, and missile system platforms; integrated technology solutions for satellite communications; products and solutions for unmanned systems; products and services related to cybersecurity and cyberwarfare; products and solutions for ballistic missile defense; weapons systems trainers; advanced network engineering and information technology services; weapons systems lifecycle support and sustainment; military weapon range operations and technical services; and public safety, critical infrastructure security and surveillance systems. We believe our stable client base, strong client relationships, broad array of contract vehicles, large employee base possessing specialized skills, extensive list of past performance qualifications, and significant management and operational capabilities position us for continued growth.

We were incorporated in the state of New York on December 19, 1994 and began operations in March 1995. We reincorporated in the state of Delaware in 1998.

Industry Update

In August 2011, Congress and the Administration enacted the Budget Control Act of 2011 (the “Budget Control Act”) in order to permit an increase in the federal government's borrowing limit while reducing projected net government spending over the following ten years. The Budget Control Act required $900 billion in immediate cuts to discretionary spending for 2012-2021. It also established a bi-partisan congressional Joint Select Committee on Deficit Reduction (the “Joint

Committee"), which was charged with recommending legislation that would reduce net government spending by $1.2 to $1.5 trillion over the next 10 years, in addition to the $900 billion in immediate discretionary spending reductions referenced above. The Joint Committee was unable to identify the required reductions, thereby triggering a provision of the Budget Control Act called "sequestration," which requires very substantial automatic spending cuts, split between defense and non-defense programs, that started in 2013 and continues over a nine-year period.

In January 2013, Congress enacted the American Taxpayer Relief Act of 2012. It addressed a number of tax code provisions and certain spending issues but left in place the sequester (although delaying its implementation to March 1, 2013) and did not address other fiscal matters such as the debt ceiling. Although debate on budget reductions continued through the first two months of 2013, no resolution was reached prior to the March 1, 2013 sequester deadline. As a result, the President was required by law to issue an order canceling $85 billion in budgetary resources across the U.S. Government for the remainder of FY 2013. The Office of Management and Budget ("OMB") in its report to Congress on March 1, 2013, entitled "OMB Report to the Congress on the Joint Committee Sequestration," calculated that, over the course of the fiscal year, the order requires a 7.8 percent reduction in non-exempt defense discretionary funding and a 5.0 percent reduction in non-exempt non-defense discretionary funding. The sequestration also requires reductions of 7.9 percent to non-exempt defense mandatory programs. The sequestration report provides calculations of the amounts and percentages by which various budgetary resources are required to be reduced, and a listing of the reductions required for each non-exempt budget account. Federal agencies were directed to apply the same percentage reduction to all programs, projects, and activities within a budget account, as required by Section 256(k)(2) of Balanced Budget and Emergency Deficit Control Act, as amended ("BBEDCA"), and to operate in a manner that is consistent with guidance provided by OMB in Memorandum 13-03, Planning for Uncertainty with Respect to Fiscal Year 2013 Budgetary Resources and Memorandum 13-05, Agency Responsibilities for Implementation of Potential Joint Committee Sequestration.

The delay in the sequester has left the DoD less time to enact 2013 automatic spending cuts and adds to the uncertainty from such cuts. The nation's debt ceiling is currently expected to be reached in the fall of 2013. The U.S. Government continues to face substantial fiscal and economic challenges that affect funding for its discretionary and non-discretionary budget. On March 26, 2013, the President signed into law the Consolidated and Further Continuing Appropriations Act, 2013, which includes specific appropriations for our major federal customers, including the DoD. Although we are not yet able to determine all program specific impacts, we expect the reduced FY 2013 budget levels will result in lower 2013 awards on some of our programs and the related impacts to company revenues, earnings and cash flows will likely follow reduced awards.

On April 10, 2013, the President delivered his proposed FY 2014 budget to Congress. The President's $527 billion FY 2014 defense budget is slightly lower than final defense appropriations for FY 2013. While it largely reflects defense spending plans in the FY 2013 budget, it does not reflect the reductions mandated by Part II of the Budget Control Act. The Congressional appropriation and authorization of FY 2014 defense spending is likely to be marked by significant debate and an uncertain schedule. In addition, if Congress does not timely pass a FY 2014 defense appropriation or a continuing resolution, we may be required to continue to perform for some period of time on certain of our U.S. Government contracts even if the U.S. Government is unable to make timely payments.

Despite the sequestration order and the budget debate, we believe that spending on modernization and maintenance of foundational and strategic defense, national and homeland security assets will continue to be a national priority. The vast majority of our programs are funded in the DoD Base budget and not the Overseas Contingency Operations budget. We also believe that our business is aligned with mission critical national security priorities, particularly in the areas of unmanned aerial vehicles, cybersecurity, electronic warfare, ballistic missile defense, satellite communications, space programs and science and technology efforts. Nevertheless, the actual impact of sequestration and the federal budget debates are uncertain at this time, and we cannot assure you that these events will not have a significant adverse effect on our business and results of operations. See the risk factor entitled "The U.S. Government provides a significant portion of our revenue, and our business could be adversely affected by changes in the fiscal policies of the U.S. Government and governmental entities” in Part II, Item 1A, "Risk Factors" of the Form 10-K.

Reporting Segments

We operate in two principal business segments: Kratos Government Solutions (“KGS”) and Public Safety & Security (“PSS”). We organize our business segments based on the nature of the services offered. Transactions between segments are generally negotiated and accounted for under terms and conditions similar to other government and commercial contracts, and these intercompany transactions are eliminated in consolidation. The condensed consolidated financial statements in this Form 10-Q are presented in a manner consistent with our operating structure. For additional information regarding our

Table of Contents

operating segments, see Note 12 of the notes to the condensed consolidated financial statements. From a customer and solutions perspective, we view our business as an integrated whole, leveraging skills and assets wherever possible.

Strategic Acquisitions

We have supplemented our organic growth by identifying, acquiring and integrating businesses that meet our primary objective of providing us with enhanced capabilities to pursue a broader cross section of the DoD, Department of Homeland Security ("DHS") and other government markets, complement and broaden our existing client base and expand our primary service offerings. Our senior management team has significant acquisition experience.

On July 2, 2012, we completed the acquisition of CEi for approximately $164.0 million. The purchase price, including an adjustment for working capital and cash paid to the shareholders for the 338(h)(10) election, included $135.0 million in cash and 4.0 million shares of our common stock, valued at $5.94 per share on July 2, 2012, or $23.8 million. $10.7 million of the cash paid was placed into an escrow account as security for CEi's indemnification obligations as set forth in the CEi purchase agreement and was reduced by $1.0 million to pay the working capital adjustment paid to us in July 2013. In addition, $2.5 million was paid to retire certain pre-existing CEi debt and settle pre-existing accounts receivable from CEi at its carrying and fair value of $3.0 million. We made an election under Section 338(h)(10) of the Internal Revenue Code, which resulted in tax deductible goodwill related to this transaction and as a result paid approximately $1.6 million in additional tax liability incurred by the shareholders of CEi for this election. We estimate the tax deductible goodwill and intangibles is approximately $140.6 million and can be deducted for federal and California state income taxes over a 15-year period.

In connection with the completion of the CEi transaction, certain CEi personnel entered into long-term employment agreements with us. On July 2, 2012, we granted restricted stock units ("RSUs") for an aggregate of 2.0 million shares of common stock as long-term retention inducement grants to certain employees of CEi who joined Kratos. The RSUs had an estimated value of $11.9 million on the grant date, vest on the fourth anniversary of the closing of the CEi acquisition, or earlier upon the occurrence of certain events, and are being accounted for as compensation expense over such four-year period.

To fund the acquisition of CEi, on May 14, 2012, the Company sold approximately 20.0 million shares of its common stock at a purchase price of $5.00 per share in an underwritten public offering. We received gross proceeds of approximately $100.0 million and net proceeds of approximately $97.0 million after deducting underwriting fees and other offering expenses. We used the net proceeds from this offering to fund a portion of the purchase price for the acquisition of CEi. In addition, we borrowed $40.0 million from our revolving line of credit to fund the purchase price of CEi.

CEi is a vertically integrated manufacturer and developer of unmanned aerial target systems and composite structures used for national security programs. Its drones are designed to replicate some of the most lethal aerial threats facing warfighters and strategic assets. CEi's customers include U.S. and foreign governments.

On December 30, 2011, we acquired selected assets of a Critical Infrastructure Business for approximately $18.8 million, which includes a final agreement on the working capital adjustment.

The Critical Infrastructure Business designs, engineers, deploys, manages and maintains specialty security systems at some of the most strategic asset and critical infrastructure locations in the U.S. Additionally, these security systems are typically integrated into command and control system infrastructure or command centers. Approximately 15% of the revenues of the Critical Infrastructure Business are recurring in nature due to the operation, maintenance or sustainment of the security systems once deployed.

Key Financial Statement Concepts

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

As of June 30, 2013, we consider the following factors to be important in understanding our financial statements.

KGS' business with the U.S. Government and prime contractors is generally performed under cost reimbursable, fixed-price or time and materials contracts. Cost reimbursable contracts for the U.S. Government provide for reimbursement of costs plus the payment of a fee. Some cost reimbursable contracts include incentive fees that are awarded based on performance on the contract. Under time and materials contracts, we are reimbursed for labor hours at negotiated hourly billing rates and reimbursed for travel and other direct expenses at actual costs plus applied general and administrative expenses. In accounting for our long-term contracts for production of products and services provided to the U.S. Government and provided to our PSS segment customers under fixed price contracts, we utilize both cost-to-cost and units produced measures under the percentage-of-completion method of accounting under the provisions of Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") Topic 605, Revenue Recognition. Under the units produced measure of the percentage-of-completion method of accounting, sales are recognized as the units are accepted by the customer generally using sales values for units in accordance with the contract terms. We estimate profit as the difference between total estimated revenue and total estimated cost of a contract and recognize that profit over the life of the contract based on deliveries or as computed on the basis of the estimated final average unit costs plus profit. We classify contract revenues as product sales or service revenues depending upon the predominant attributes of the relevant underlying contracts.

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

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

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

Comparison of Results for the Three Months Ended June 24, 2012 to the Three Months Ended June 30, 2013

Revenues. Revenues increased $15.4 million from $219.8 million for the three months ended June 24, 2012 to $235.2 million for the three months ended June 30, 2013. KGS segment revenue increased by $7.7 million. This increase was primarily due to revenues of $27.2 million from our CEi acquisition, partially offset by the timing of shipments of products primarily in our ground equipment and electronic warfare businesses, continued ongoing weakness and increased competition in our legacy government services businesses of $4.4 million and delay of service programs as a result of the continuing resolution and uncertainty related to sequestration. PSS segment revenue increased by $7.7 million due to organic growth primarily driven by revenue from large metropolitan transit authority programs.

Revenues by operating segment for the three months ended June 24, 2012 and June 30, 2013 are as follows (dollars in millions):

Table of Contents

	June 24, 2012	June 30, 2013	$ change	% change
Kratos Government Solutions				
Service revenues	$68.1	$58.5	$(9.6)	(14.1)%
Product sales	107.7	$125.0	17.3	16.1%
Total Kratos Government Solutions	175.8	183.5	7.7	4.4%
Public Safety & Security				
Service revenues	44.0	$51.7	7.7	17.5%
Product sales	—	$—	—	—%
Total Public Safety & Security	44.0	51.7	7.7	17.5%
Total revenues	$219.8	$235.2	$15.4	7.0%

Product sales increased $17.3 million from $107.7 million for the three months ended June 24, 2012 to $125.0 million for the three months ended June 30, 2013, primarily as a result of the CEi acquisition which was offset by timing of shipments as discussed above. As a percentage of total revenue, product sales were 49.0% for the three months ended June 24, 2012 as compared to 53.1% for the three months ended June 30, 2013. The increase in product sales was primarily related to the acquisition of CEi. Service revenues decreased by $1.9 million from $112.1 million for the three months ended June 24, 2012 to $110.2 million for the three months ended June 30, 2013. The decrease was primarily related to the reductions in the legacy government service revenue in other business units in the KGS segment, partially offset by the organic growth in the PSS segment.

Cost of Revenues. Cost of revenues increased $12.7 million from $162.1 million for the three months ended June 24, 2012 to $174.8 million for the three months ended June 30, 2013. The increase in cost of revenues was primarily a result of the changes discussed above.

Gross margin decreased from 26.3% for the three months ended June 24, 2012 to 25.7% for the three months ended June 30, 2013. Margins on services increased for the three months ended June 24, 2012 as compared to June 30, 2013, from 22.7% to 24.4%, respectively, due primarily to increased margins in our KGS segment. Margins on products decreased for the three months ended June 24, 2012 as compared to June 30, 2013 from 30.0% to 26.8%, respectively, as a result of a mix of products shipped. Margins in the KGS segment decreased from 25.9% for the three months ended June 24, 2012 to 25.3% for the three months ended June 30, 2013, primarily as a result of the mix of products shipped. Margins in the PSS segment remained fairly flat at 27.7% for the three months ended June 24, 2012 and 27.1% for the three months ended June 30, 2013.

Selling, General and Administrative Expenses. Selling, general and administrative expenses (“SG&A”) increased $5.4 million from $42.6 million for the three months ended June 24, 2012 to $48.0 million for the three months ended June 30, 2013. The increase was primarily a result of the acquisition of CEi. As a percentage of revenues, SG&A increased from 19.4% to 20.4%. Excluding amortization of intangibles of $8.9 million for the three months ended June 24, 2012 and amortization of intangibles of $9.0 million for the three months ended June 30, 2013, SG&A increased as a percentage of revenues from 15.3% to 16.6% for the three months ended June 24, 2012 and June 30, 2013, respectively, as a result of increases in certain infrastructure costs including information technology, network security, and non-recurring audit fees related to our change in external auditors.

Merger and Acquisition Expenses. Merger and acquisition expenses of $1.5 million for the three months ended June 24, 2012, were primarily related to the acquisition of CEi. The benefit of $2.6 million for the three months ended June 30, 2013, was due to the reduction in a $3.1 million liability as a result of the final settlement of our indemnity obligations related to former directors and officers of Integral on July 1, 2013, partially offset by a $0.4 million of legal fees on another matter related to a prior acquisition. See Note 13 of the Notes to the Condensed Consolidated Financial Statements for a further discussion of our indemnity obligations.

Research and Development Expenses. Research and development expenses were $4.8 million for the three months ended June 24, 2012 and for the three months ended June 30, 2013 .

Unused office space and other restructuring. The expense of $1.4 million for the three months ended June 24, 2012 was a result of an increase in our excess facility accrual due to consolidation of office space at our Lanham, Maryland administrative facilities. The expense of $1.3 million for the three months ended June 30, 2013 was due to expenses related to workforce reductions as a result of cost saving initiatives we have implemented across the Company.

Table of Contents

Other Expense, Net. Other expense, net increased from $15.7 million to $16.1 million for the three months ended June 24, 2012 and June 30, 2013, respectively. The increase in expense of $0.4 million is primarily related to a year over year reduction in the benefit of foreign currency transaction gains.

Provision (Benefit) for Income Taxes. Income tax expense for the three months ended June 24, 2012 was $6.6 million and the income tax benefit for the three months ended June 30, 2013 was $0.1 million, on a loss before income taxes of $8.3 million and $7.2 million, respectively. The tax expense of $6.6 million and benefit of $0.1 million for the three months ended June 24, 2012 and June 30, 2013, respectively, were primarily a function of the estimated effective tax rate for the respective years. The estimated effective tax rate for any given year is driven by estimated foreign taxes, estimated state taxes, permanent book/tax differences, tax amortization of intangible assets that have an indefinite life under GAAP and the projected income or loss for the year. For the three months ended June 30, 2013, the benefit for income taxes was due to a reduction in the reserve for uncertain tax positions of $1.6 million as a result of the expiration of the statute of limitations.

Income from Discontinued Operations. Revenue from discontinued operations was $1.8 million and $0.5 million, tax expense was $0.0 million and $0.0 million, and loss from discontinued operations was $2.3 million and $2.5 million for the three months ended June 24, 2012 and June 30, 2013, respectively. The revenue and income for the three months ended June 24, 2012 and June 30, 2013 was primarily related to operations of the non-core businesses from the Integral acquisition that have been classified as held for sale. See Note 8 of the Notes to the Condensed Consolidated Financial Statements for a further discussion of our discontinued operations.

Comparison of Results for the Six Months Ended June 26, 2012 to the Six Months Ended June 24, 2013

Revenues. Revenues increased $59.2 million from $429.3 million for the six months ended June 24, 2012 to $488.5 million for the six months ended June 30, 2013. KGS segment revenue increased by $41.5 million. This increase was primarily due to revenues of $53.1 million from our CEi acquisition as well as organic growth in our cyber security businesses, partially offset by the timing of shipments of products primarily in our electronic warfare businesses, continued ongoing weakness and increased competition in our legacy government services businesses of $7.5 million and delay of service programs as a result of the continuing resolution and uncertainty related to sequestration. PSS segment revenue increased by $17.7 million which was primarily due to the organic growth driven partially by an increase in revenue of $11.6 million from large metropolitan transit authority programs. Revenues by operating segment for the six months ended June 24, 2012 and June 30, 2013 are as follows (dollars in millions):

	June 24, 2012	June 30, 2013	$ change		% change	
Kratos Government Solutions						
Service revenues	$ 129.6	$ 123.9	$ (5.7	)	(4.4	)%
Product sales	215.1	262.3	47.2		21.9	%
Total Kratos Government Solutions	344.7	386.2	41.5		12.0	%
Public Safety & Security						
Service revenues	84.6	102.3	17.7		20.9	%
Product sales	—	—	—		—	%
Total Public Safety & Security	84.6	102.3	17.7		20.9	%
Total revenues	$ 429.3	$ 488.5	$ 59.2		13.8	%

Product sales increased $47.2 million from $215.1 million for the six months ended June 24, 2012 to $262.3 million for the six months ended June 30, 2013. As a percentage of total revenue, product sales were 50.1% for the six months ended June 24, 2012 as compared to 53.7% for the six months ended June 30, 2013. This increase was primarily related to the acquisition of CEi. Service revenues increased by $12.0 million from $214.2 million for the six months ended June 24, 2012 to $226.2 million for the six months ended June 30, 2013. The increase was primarily related to the organic growth in the PSS segment, partially offset by the reductions in the legacy government service revenue in other business units in the KGS segment as discussed above.

Cost of Revenues. Cost of revenues increased from $314.2 million for the six months ended June 24, 2012 to $362.3 million for the six months ended June 30, 2013. The $48.1 million increase in cost of revenues was primarily a result of the acquisitions of CEi and costs related to revenue from organic growth in our PSS segment as discussed above.

Table of Contents

Gross margin decreased from 26.8% for the six months ended June 24, 2012 to 25.8% for the six months ended June 30, 2013. Margins on services increased from 22.3% for the six months ended June 24, 2012 to 24.0% for the six months ended June 30, 2013, due primarily to increased margins in our KGS segment. Margins on products decreased for the six months ended June 24, 2012 as compared to June 30, 2013 from 31.3% to 27.4%, respectively, as a result of an increase in the shipment of specialized ground equipment in the first quarter, which has lower margins than other products and the overall mix of products shipped. Margins in the KGS segment decreased from 26.8% for the six months ended June 24, 2012 to 25.8% for the six months ended June 30, 2013 primarily as a result of reduction in margins on products. Margins in the PSS segment decreased slightly from 26.7% for the six months ended June 24, 2012 to 26.2% for the six months ended June 30, 2013.

Selling, General and Administrative Expenses. SG&A increased $10.7 million from $86.4 million for the six months ended June 24, 2012 to $97.1 million for the six months ended June 30, 2013. The increase was primarily a result of the acquisitions of CEi which had SG&A of $6.9 million. As a percentage of revenues, SG&A decreased from 20.1% to 19.9%. Excluding amortization of intangibles of $19.4 million for the six months ended June 24, 2012 and amortization of intangibles of $18.3 million for the six months ended June 30, 2013, SG&A increased as a percentage of revenues from 15.6% to 16.1% for the six months ended June 24, 2012 and June 30, 2013, respectively, reflecting increases in certain infrastructure costs including information technology, network security, and non-recurring audit fees related to our change in external auditors.

Merger and Acquisition Expenses. Merger and acquisition expenses of $2.4 million for the six months ended June 24, 2012, were primarily related to the acquisition of CEi. The benefit of $2.5 million for the six months ended June 30, 2013, was due to the reduction in a $3.1 million liability as a result of the final settlement of our indemnity obligations related to former directors and officers of Integral on July 1, 2013, partially offset by other merger expenses and legal fees related to prior acquisitions. See Note 13 of the Notes to the Condensed Consolidated Financial Statements for a further discussion of our indemnity obligations.

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Research and Development Expenses. Research and development expenses increased from $8.4 million for the six months ended June 24, 2012 to $9.7 million for the six months ended June 30, 2013, primarily due to select investments we are making to enhance certain satellite and electronic warfare/electronic attack products and the acquisition of CEi.

Unused office space and other resttucturing. The expense of $1.4 million for the six months ended June 24, 2012 was a result of an increase in our excess facility accrual due to consolidation of office space at our Lanham, Maryland administrative facilities. The expense of $1.6 million for the six months ended June 30, 2013 was due to expenses related to workforce reductions as a result of cost saving initiatives we have implemented across the Company.

Other Expense, Net. Other expense, net increased from $31.4 million to $33.1 million for the six months ended June 24, 2012 and June 30, 2013, respectively. The increase in expense of $1.7 million is primarily related to a change in foreign currency transactions. We had other income of $0.9 million and other expense of $0.6 million for the six months ended June 24, 2012 and June 30, 2013, respectively, primarily related to foreign currency transactions.

Provision for Income Taxes. We recorded an income tax expense of $2.5 million on a loss of $14.9 million before income taxes for the six months ended June 24, 2012. The expense of $2.5 million was primarily related to state and foreign taxes. We recorded an income tax expense of $2.7 million on a loss of $12.8 million before income taxes for the six months ended June 30, 2013. This expense was related to state and foreign taxes which were offset by a reduction in the reserve for uncertain tax positions of $1.6 million as a result of the expiration of the statute of limitations.

Income from Discontinued Operations. Revenue from discontinued operations was $7.4 million and $3.6 million, tax expense was $0.1 million and $0.0 million, and loss from discontinued operations was $2.8 million and $4.4 million for the six months ended June 24, 2012 and June 30, 2013, respectively. The revenue and income for the six months ended June 24, 2012 and June 30, 2013 was primarily related to operations of the non-core businesses from the Integral acquisition that have been classified as held for sale. During the six months ended June 30, 2013, we recorded a $1.2 million impairment charge related to our revised estimate of the fair value of these operations. See Note 8 of the Notes to the Condensed Consolidated Financial Statements for a further discussion of our discontinued operations.

Backlog

As of June 24, 2012 and June 30, 2013, our backlog was approximately $1.1 billion and $1.1 billion, respectively, of which $546.0 million was funded in 2012 and $558.0 million was funded in 2013. Backlog is our estimate of the amount of revenue we expect to realize over the remaining life of awarded contracts and task orders that we have in hand as of the measurement date. Our total backlog consists of funded and unfunded backlog. We define funded backlog as estimated future revenue under government contracts and task orders for which funding has been appropriated by Congress and authorized for expenditure by the applicable agency, plus our estimate of the future revenue we expect to realize from our commercial contracts that are under firm orders. Our funded backlog does not include the full potential value of our contracts because Congress often appropriates funds to be used by an agency for a particular program of a contract on a yearly or quarterly basis even though the contract may call for performance over a number of years. As a result, contracts typically are only partially funded at any point during their term, and all or some of the work to be performed under the contracts may remain unfunded unless and until Congress makes subsequent appropriation and the procuring agency allocates funding to the contract.

Unfunded backlog reflects our estimate of future revenue under awarded government contracts and task orders for which either funding has not yet been appropriated or expenditure has not yet been authorized. Our total backlog does not include estimates of revenue from government-wide acquisition contracts or General Services Administration schedules beyond awarded or funded task orders, but our unfunded backlog does include estimates of revenue beyond awarded or funded task orders for other types of indefinite delivery, indefinite quantity contracts based on our experience under such contracts and similar contracts. Unfunded backlog also includes priced options, which consist of the aggregate contract revenues expected to be earned as a result of a customer exercising an option period that has been specifically defined in the original contract award.

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

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

Liquidity and Capital Resources

As of June 30, 2013, we had cash and cash equivalents of $49.7 million compared with cash and cash equivalents of $49.0 million as of December 30, 2012, which includes $21.2 million and $15.2 million, respectively, of cash and cash equivalents held by our foreign subsidiaries. We are not presently aware of any restrictions on the repatriation of these funds, although a portion may be considered permanently invested in these foreign subsidiaries. If these funds were needed to fund our operations or satisfy obligations in the U.S. they could be repatriated, and their repatriation into the U.S. may cause us to incur additional U.S. income taxes or foreign withholding taxes. Any additional taxes could be offset, in part or in whole, by foreign tax credits. The amount of such taxes and application of tax credits would be dependent on the income tax laws and other circumstances at the time these amounts are repatriated. Based on these variables, it is not practicable to determine the income tax liability that might be incurred if these earnings were to be repatriated. We do not currently intend to repatriate these earnings.

Our total debt, including capital lease obligations, principal due on the Notes, other term debt, and the premium of $16.6 million received on Notes issued, decreased by $2.8 million from $650.3 million on December 30, 2012 to

$647.5 million on June 30, 2013. The decrease in debt was primarily the result of the amortization of the premium on the Notes of approximately $2.1 million and a $0.5 million principal payment on a ten-year term loan with a bank in Israel.

Our operating cash flow is used to finance trade accounts receivable, fund necessary increases in inventory, fund capital expenditures and our ongoing operations, service our debt and make strategic acquisitions. Financing trade accounts receivable is necessary because, on average, our customers do not pay us as quickly as we pay our vendors and employees for their goods and services. Financing increases in inventory balances is necessary to fulfill shipment requirements to meet delivery schedules of our customers. Cash from continuing operations is primarily derived from our customer contracts in progress and associated changes in working capital components. Our accounts receivable balance of $253.6 million at June 30, 2013 includes $1.4 million of receivables due from a Greek customer under a subcontract arrangement Gichner Holdings, Inc. ("Gichner") entered into with the Greek Ministry of Defense (GMoD) in 2004 prior to our acquisition of Gichner in 2010. After numerous delays by our customer and the GMoD, activity has resumed on the project. We currently expect product shipments to continue through late 2013 when the final shipment is delivered. We do not have any significant direct exposure to European government receivables, and our customers do not rely heavily on European government subsidies or other European government support. We will continue to monitor our exposure to risks relating to European sovereign debt.

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

	Six Months Ended	
	June 24, 2012	June 30, 2013
Net cash provided by operating activities from continuing operations	$9.8	$8.4

Cash provided by operating activities from continuing operations includes $2.9 million and $0.5 million in transaction costs paid related to our acquisitions for the six months ended June 24, 2012 and June 30, 2013, respectively.

Our cash used in investing activities from continuing operations is summarized as follows (in millions):

	Six Months Ended	
	June 24, 2012	June 30, 2013
Investing activities:		
Cash paid for acquisitions, net of cash acquired	$(21.5)	$1.2
Decrease in restricted cash	0.3	0.2
Proceeds from the sale of discontinued operations	—	0.4
Capital expenditures	(6.2)	(7.3)
Net cash used in investing activities from continuing operations	$(27.4)	$(5.5)

Cash paid for acquisitions was the most significant outlay for investing activities for the six months ended June 24, 2012, as a result of the implementation of our strategy to diversify our business through strategic acquisitions. On December 30, 2011, we acquired selected assets of the Critical Infrastructure Business for approximately $18.8 million. We paid $20.0 million related to this acquisition in 2012 and received payment of $1.2 million on the settlement of the working capital in 2013. In March 2012, we paid $1.5 million related to the contingent acquisition consideration for SecureInfo for performance milestones achieved in 2011.

Capital expenditures consist primarily of investment in machinery, computer hardware and software, and improvement of our physical properties in order to maintain suitable conditions in which to conduct our business. The increase in capital expenditures of $1.1 million from $6.2 million for the six months ended June 24, 2012 to $7.3 million for the six months ended June 30, 2013 was primarily a result of capital equipment expenditures made by CEi.

Cash used in financing activities from continuing operations is summarized as follows (in millions):

	Six Months Ended	
	June 24, 2012	June 30, 2013
Financing activities:		
Proceeds from the issuance of common stock	97.0	—
Cash paid for contingent acquisition consideration	(2.5)	(2.1)
Repayments of debt	(0.5)	(0.5)
Debt issuance costs	(1.0)	—
Other	(0.3)	(0.3)

Net cash used in financing activities from continuing operations	$92.7	$(2.9)

Table of Contents

On May 15, 2012, we sold 20.0 million shares of common stock at a purchase price of $5.00 per share in an underwritten public offering. We received gross proceeds of $100.0 million. After deducting underwriting and other offering expenses, we received approximately $97.0 million in net proceeds. We used the net proceeds from this offering to fund a portion of the cash consideration paid to the stockholders of CEi in connection with our acquisition of CEi on July 2, 2012.

In April 2012, we paid $2.5 million in contingent acquisition consideration related to the DEI performance milestones achieved in 2011. In April of 2013 the remaining DEI Contingent Consideration of $2.1 million was paid.

Cash provided by discontinued operations is summarized as follows (in millions):

	Six Months Ended	
	June 24, 2012	June 30, 2013
Net cash flows provided by discontinued operations	$1.3	$0.8

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

Contractual Obligations and Commitments

In order to fund our acquisitions in 2011 and 2012, we issued equity and increased our leverage through a series of financing transactions.

Issuance of 10% Senior Secured Notes due 2017

On May 19, 2010, we entered into an indenture with the guarantors set forth therein and Wilmington Trust FSB, as trustee and collateral agent (as amended or supplemented the “Indenture”), to issue the Notes. As of June 30, 2013, we have issued Notes in the aggregate principal amount of $625.0 million under the Indenture, of which $225.0 million were issued on May 19, 2010, $285.0 million were issued on March 25, 2011 at a $20.0 million premium and an effective interest rate of 8.5 % and $115.0 million were issued on July 27, 2011 at a $5.8 million premium and an effective interest rate of 8.9%. These Notes have been used to fund acquisitions and for general corporate purposes. The holders of the Notes have a first priority lien on substantially all of our assets and the assets of the guarantors, except with respect to accounts receivable, inventory, deposit accounts, securities accounts, cash, securities and general intangibles (other than intellectual property), on which the holders of the Notes have a second priority lien to the $110.0 million credit facility described below.

We pay interest on the Notes semi-annually, in arrears, on June 1 and December 1 of each year. The Notes include customary covenants and events of default as well as a consolidated fixed charge ratio of 2:1 for the incurrence of additional indebtedness. Negative covenants include, among other things, limitations on additional debt, liens, negative pledges, investments, dividends, stock repurchases, asset sales and affiliate transactions. Events of default include, among other events, non-performance of covenants, breach of representations, cross-default to other material debt, bankruptcy, insolvency, material judgments and changes in control. As of June 30, 2013, we were in compliance with the covenants contained in the Indenture governing the Notes.

On or after June 1, 2014, we may redeem some or all of the Notes at 105% of the aggregate principal amount of such Notes through June 1, 2015, 102.5% of the aggregate principal amount of such Notes through June 1, 2016 and 100% of the aggregate principal amount of such Notes thereafter, plus accrued and unpaid interest to the date of redemption.

Prior to June 1, 2013, we may redeem up to 35% of the aggregate principal amount of the Notes at 110% of the aggregate principal amount of the Notes, plus accrued and unpaid interest to the date of redemption, with the net cash proceeds of certain equity offerings. In addition, we may, at our option, redeem some or all of the Notes at any time prior to June 1, 2014, by paying a “make whole” premium, plus accrued and unpaid interest, if any, to the date of redemption. The Company may also at any time purchase outstanding Notes traded on the open market.

Other Indebtedness

$110.0 Million Credit Facility

On July 27, 2011, we entered into a credit and security agreement with KeyBank National Association (“KeyBank”), as lead arranger, sole book runner and administrative agent, and East West Bank and Bank of the West, as the lenders (the

Table of Contents

“2011 Credit Agreement”). The 2011 Credit Agreement amends and restates in its entirety the credit and security agreement, dated as of May 19, 2010, by and among the Company, KeyBank and the lenders named therein (as amended). The 2011 Credit Agreement establishes a five-year senior secured revolving credit facility in the amount of $65.0 million (as amended as described below, the “Amended Revolver”). The Amended Revolver is secured by a lien on substantially all of our assets and the assets of the guarantors thereunder, subject to certain exceptions and permitted liens. The Amended Revolver has a first priority lien on accounts receivable, inventory, deposit accounts, securities accounts, cash, securities and general intangibles (other than intellectual property). On all other assets, the Amended Revolver has a second priority lien junior to the lien securing the Notes.

Borrowings under the Amended Revolver are subject to mandatory prepayment upon the occurrence of certain events, including the issuance of certain securities, the incurrence of certain debt and the sale or other disposition of certain assets. The Amended Revolver includes customary affirmative and negative covenants and events of default, as well as a financial covenant relating to a minimum fixed charge coverage ratio of 1.25. Negative covenants include, among other things, limitations on additional debt, liens, negative pledges, investments, dividends, stock repurchases, asset sales and affiliate transactions. Events of default include, among other events, non-performance of covenants, breach of representations, cross-default to other material debt, bankruptcy and insolvency, material judgments and changes in control.

On November 14, 2011, the Company entered into a first amendment (the “First Amendment”) with certain lenders and KeyBank that amended the 2011 Credit Agreement. Among other things, the First Amendment: (i) increased the amount of the Amended Revolver from $65.0 million to $90.0 million; (ii) added to and modified the definitions of certain terms contained in the 2011 Credit Agreement; (iii) added PNC Bank, National Association as a lender under the 2011 Credit Agreement; and (iv) updated certain schedules to the 2011 Credit Agreement.

On May 4, 2012, we entered into a second amendment (the "Second Amendment") to the 2011 Credit Agreement. Among other things, the Second Amendment (i) increased the amount of the Amended Revolver from $90.0 million to $110.0 million, (ii) added to and modified the definitions of certain terms contained in the 2011 Credit Agreement, (iii) added Cathay Bank as a lender under the 2011 Credit Agreement, (iv) increased the maximum revolving amount capacity of the 2011Credit Agreement to $135.0 million, and (v) updated certain schedules to the 2011 Credit Agreement.

On May 8, 2012, we entered into a third amendment (the "Third Amendment") to the 2011 Credit Agreement. Under the terms of the Third Amendment, the definitions of certain terms of the 2011 Credit Agreement were modified and the acquisition of CEi was approved. We used the net proceeds from the sale of 20.0 million shares of our common stock, together with a $40.0 million borrowing under the Amended Revolver, to fund the purchase of the CEi and to pay related fees and expenses. As of September 30, 2012, we repaid the $40.0 million borrowing under our credit facility.

On February 27, 2013, we entered into a fourth amendment (the "Fourth Amendment") to the 2011 Credit Agreement. Under the terms of the Fourth Amendment, the definition of certain terms of the 2011 Credit Agreement and reporting requirements were modified.

The amounts of borrowings that may be made under the Amended Revolver are based on a borrowing base and are comprised of specified percentages of eligible receivables, eligible unbilled receivables and eligible inventory. If the amount of borrowings outstanding under the Amended Revolver exceeds the borrowing base then in effect, we are required to repay such borrowings in an amount sufficient to eliminate such excess. The Amended Revolver includes $50.0 million of availability for letters of credit and $10.0 million of availability for swing line loans.

We may borrow funds under the Amended Revolver at a rate based either on LIBOR or a base rate established by KeyBank. Base rate borrowings bear interest at an applicable margin of 1.00% to 1.75% over the base rate (which will be the greater of the prime rate or 0.5% over the federal funds rate, with a floor of 1.0% over one month LIBOR). LIBOR rate borrowings will bear interest at an applicable margin of 3.00% to 3.75% over the LIBOR rate. The applicable margin for base rate borrowings and LIBOR borrowings will depend on the average monthly revolving credit availability. The Amended Revolver also has a commitment fee of 0.50% to 0.75%, depending on the average monthly revolving credit availability. As of June 30, 2013, there were no outstanding borrowings on the Amended Revolver and $14.2 million was outstanding on letters of credit resulting in net borrowing base availability of $69.3 million. We were in compliance with the financial covenants as of June 30, 2013.

Debt Acquired in Acquisition of Herley

We assumed a $10.0 million ten-year term loan with a bank in Israel that Herley entered into on September 16, 2008 in connection with the acquisition of one of its wholly owned subsidiaries. The balance as of June 30, 2013 was $5.3 million,

Table of Contents

and the loan is payable in quarterly installments of $0.3 million plus interest at LIBOR plus a margin of 1.5%. The loan agreement contains various covenants, including a minimum net equity covenant as defined in the loan agreement. We were in compliance with the financial covenants of the loan agreement as of June 30, 2013.

Contingent Consideration and Liabilities in Connection with Acquisitions

In connection with our business acquisitions, we have agreed to make additional future payments to sellers based on final purchase price adjustments and the expiration of certain indemnification obligations. Pursuant to the provisions of Topic 805, such amounts are recorded at fair value on the acquisition date.

The agreement and plan of merger entered into in connection with our acquisition of SecureInfo provided that upon achievement of certain cash receipts, revenue and EBITDA in 2011, we were obligated to pay the former stockholders of SecureInfo additional cash contingent consideration. In March 2012, we paid $1.5 million related to this contingent consideration.

Pursuant to the terms of the agreement and plan of merger with DEI Services Corporation entered into on August 9, 2010 (“the DEI Agreement”), upon achievement of certain cash receipts, revenue, EBITDA and backlog amounts in 2010, 2011 and 2012, we were obligated to pay certain additional contingent consideration (the “DEI Contingent Consideration”). We have paid $5.0 million related to the DEI Contingent Consideration, of which $2.5 million and $2.1 million was paid in April 2012 and April 2013, respectively.

Other Liquidity Matters

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

As discussed in Part II, Item 1A, “Risk Factors” of the Form 10-K, our quarterly and annual operating results have fluctuated in the past and may vary in the future due to a variety of factors, many of which are external to our control. If the conditions in our industry deteriorate or our customers cancel or postpone projects or if we are unable to sufficiently increase our revenues or further reduce our expenses, we may experience, in the future, a significant long-term negative impact to our financial results and cash flows from operations. In such a situation, we could fall out of compliance with our financial and other covenants which, if not waived, could limit our liquidity and capital resources.

Critical Accounting Principles and Estimates

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

For the six months ended June 30, 2013, there have been no significant changes to our Critical Accounting Policies or Estimates as compared to the significant accounting policies described in the Form 10-K.

Recent Accounting Pronouncements

In July 2013, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update 2013-11 ("ASU 2013-11") "Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists" which states that an unrecognized tax benefit, or a portion of an unrecognized tax benefit, should be presented in the financial statements as a reduction to a deferred tax asset for a net operating loss carryforward, a similar tax loss, or a tax credit carryforward, except as follows. To the extent a net operating loss carryforward, a similar tax loss, or a tax credit carryforward is not available at the reporting date under the tax law of the applicable jurisdiction to settle any additional income taxes that would result from the disallowance of a tax position or the tax law of the applicable jurisdiction does not require the entity to use, and the entity does not intend to use, the deferred tax asset for such purpose, the unrecognized tax benefit should be presented in the financial statements as a liability and should not be combined with deferred tax assets. The amendments in this ASU are effective for fiscal years, and interim periods within those years, beginning after December 15, 2013. The Company does not believe that the adoption of this guidance will have a material impact on its consolidated financial statements.

In February 2013, the FASB issued ASU 2013-02 "Comprehensive Income: Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income," which requires entities to provide information about the amounts reclassified out of accumulated other comprehensive income by component. In addition, entities are required to present, either on the face of the statement where net income is presented or in the notes, significant amounts reclassified out of accumulated other comprehensive income by the respective line items of net income, but only if the amount is required under GAAP to be reclassified to net income in its entirety in the same reporting period. For other amounts that are not required under GAAP to be reclassified in their entirety to net income, entities are required to cross-reference to other disclosures required under GAAP that provide additional detail on these amounts. This standard is effective prospectively for reporting periods beginning after December 15, 2012. The Company adopted this standard in the quarter ended March 31, 2013, which did not have a material impact on its consolidated financial statements.

In December 2011 and February 2013, the FASB issued an amendment to the Balance Sheet topic of the Accounting Standards Codification ("ASC"), which requires entities to disclose both gross and net information about both derivatives and transactions eligible for offset in the statement of financial position and instruments and transactions subject to an agreement similar to a master netting agreement. The objective of the disclosure is to facilitate comparison between those entities that prepare their financial statements on the basis of GAAP and those entities that prepare their financial statements on the basis of International Financial Reporting Standards. This standard is effective for fiscal years, and interim periods within those years, beginning on or after January 1, 2013. Retrospective presentation for all comparative periods presented is required. Accordingly, the Company will adopt this amendment in the first quarter of fiscal year 2014. The Company does not believe that the adoption of this guidance will have a material impact on its consolidated financial statements.

Item 3. Quantitative and Qualitative Disclosures About Market Risk.

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

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

Exposure to market risk for foreign currency exchange rate risk is related to receipts from customers, payments to suppliers and intercompany loans denominated in foreign currencies. We currently do not enter into foreign currency forward contracts to manage foreign currency exchange rate risk because to date exchange rate fluctuations have had minimal impact on our operating results and cash flows.

Cash and cash equivalents as of June 30, 2013 were $49.7 million and are primarily invested in money market interest bearing accounts. A hypothetical 10% adverse change in the average interest rate on our money market cash investments and short-term investments would have had no material effect on our net loss for the six months ended June 30, 2013.

43

Table of Contents

Item 4. Controls and Procedures.

Conclusions Regarding the Effectiveness of Disclosure Controls and Procedures

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

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

Based on the foregoing, our Principal Executive Officer and Principal Financial Officer concluded that our disclosure controls and procedures were effective at the reasonable assurance level as of June 30, 2013.

Changes in Internal Control Over Financial Reporting

There was no change in our internal control over financial reporting during the three months ended June 30, 2013 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings.

See Note 13 of the Notes to the condensed consolidated financial statements contained within this Quarterly Report on Form 10-Q for a discussion of our legal proceedings.

Item 1A. Risk Factors.

In evaluating us and our common stock, we urge you to carefully consider the risks and other information in this Quarterly Report on Form 10-Q, as well as the risk factors disclosed in Item 1A. to Part I of our Annual Report on Form 10-K for the fiscal year ended December 30, 2012, which we filed with the SEC on March 12, 2013. The risks and uncertainties described in “Item 1A - Risk Factors” of our Annual Report on Form 10-K have not materially changed. Any of the risks discussed in this Quarterly Report on Form 10-Q or any of the risks disclosed in Item 1A. to Part I of our Annual Report on Form 10-K for the fiscal year ended December 30, 2012, as well as additional risks and uncertainties not currently known to us or that we currently deem immaterial, could materially and adversely affect our results of operations or financial condition.

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

There were no unregistered sales of the Company's equity securities during the six month period ended June 30, 2013 that were not previously disclosed in a Current Report on Form 8-K.

Item 3. Defaults Upon Senior Securities.

None.

Item 4. Mine Safety Disclosures.

Not applicable.

Table of Contents

Item 5. Other Information.

None.

Table of Contents

Item 6. Exhibits.

Exhibit Number	Exhibit Description	Incorporated by Reference Form	Filing Date/ Period End Date	Exhibit	Filed-Furnished Herewith
2.1#	Stock Purchase Agreement, dated May 8, 2012, by and among Kratos Defense & Security Solutions, Inc., Composite Engineering, Inc., and Amy Fournier, the stockholders representative	8-K	05/08/2012	2.1	
2.2#	Agreement and Plan of Merger, dated May 15, 2011, by and among Kratos Defense & Security Solutions, Inc., Integral Systems, Inc., IRIS Merger Sub Inc., and IRIS Acquisition Sub LLC.	8-K	05/18/2011	2.1	
2.3#	Agreement and Plan of Merger, dated February 7, 2011, by and among Kratos Defense & Security Solutions, Inc., Lanza Acquisition, Co. and Herley Industries, Inc. (incorporated by reference to Annex A to the Prospectus Supplement dated February 8, 2011, pursuant to the Registration Statement on Form S-3 of Kratos Defense & Security Solutions, Inc.)	424	02/08/2011	n/a	
3.1	Amended and Restated Certificate of Incorporation of Kratos Defense & Security Solutions, Inc.	10-Q	09/30/2001	4.1	
3.2	Certificate of Ownership and Merger of Kratos Defense & Security Solutions, Inc. into Wireless Facilities, Inc.	8-K	09/14/2007	3.1	
3.3	Certificate of Amendment to Amended and Restated Certificate of Incorporation of Kratos Defense & Security Solutions, Inc.	10-Q	09/27/2009	3.1	
3.4	Certificate of Designations, Preferences and Rights of Series A Preferred Stock.	10-Q	09/30/2001	4.2	
3.5	Certificate of Designations, Preferences and Rights of Series B Preferred Stock (included as Exhibit A to the Preferred Stock Purchase Agreement dated as of May 16, 2002 among the Company, Meritech Capital Partners II L.P., Meritech Capital Affiliates II L.P., MCB Entrepreneur Partners II L.P., Oak Investment Partners X, Limited	8-K/A	06/05/2002	4.1	

	Partnership, Oak X Affiliates Fund, Limited Partnership, Oak Investment Partners IX, L.P, Oak Affiliates Fund, L.P, Oak IX Affiliates Fund-A, L.P, and the KLS Trust dated July 14, 1999).			
3.6	Certificate of Designation of Series C Preferred Stock.	8-K	12/17/2004	3.1
3.7	Second Amended and Restated Bylaws of Kratos Defense & Security Solutions, Inc.	8-K	03/15/2011	3.1
4.1	Specimen Stock Certificate.	10-K	12/26/2010	4.1
4.2	Rights Agreement, dated as of December 16, 2004, between Kratos Defense & Security Solutions, Inc. and Wells Fargo, N.A.	8-K	12/17/2004	4.1
4.3	Amendment No. 1 to Rights Agreement, dated as of May 14, 2012, between Kratos Defense & Security Solutions, Inc. and Wells Fargo, N.A.	8-K	05/15/2012	4.1

Table of Contents

Exhibit Number	Exhibit Description	Incorporated by Reference Form	Filing Date/ Period End Date	Exhibit	Filed-Furnished Herewith
4.4	Indenture, dated as of May 19, 2010, by and among Kratos Defense & Security Solutions, Inc., the Guarantors set forth therein and Wilmington Trust FSB, as Trustee and Collateral Agent (including the Form of 10% Senior Secured Notes due 2017 as an exhibit thereto).	8-K	05/25/2010	4.1	
4.5	First Supplemental Indenture, dated as of February 7, 2011, by and among Kratos Defense & Security Solutions, Inc., the guarantors listed on Exhibit A thereto and Wilmington Trust FSB, to the Indenture, dated as of May 19, 2010 (as amended or supplemented), among Kratos Defense & Security Solutions, Inc., the guarantors party thereto and Wilmington Trust FSB, as trustee and collateral agent.	8-K	02/07/2011	10.2	
4.6	Supplemental Indenture, dated April 1, 2011, among the guaranteeing subsidiaries named therein and Wilmington Trust FSB, as trustee, to the Indenture (as amended or supplemented), dated as of May 19, 2010, among Kratos Defense & Security Solutions, Inc., the guarantors party thereto and Wilmington Trust FSB, as trustee and collateral agent.	8-K	04/07/2011	4.1	
4.7	Third Supplemental Indenture, dated April 15, 2011, by and among Kratos Defense & Security Solutions, Inc., the guaranteeing subsidiaries named therein and Wilmington Trust FSB, as trustee and collateral agent, to the Indenture, dated as of May 19, 2010 (as amended or supplemented), among Kratos Defense & Security Solutions, Inc., the guarantors party thereto and Wilmington Trust FSB, as trustee and collateral agent.	8-K	04/20/2011	4.1	
4.8	Sixth Supplemental Indenture, dated July 27, 2011, by and among Kratos Defense & Security Solutions, Inc., the guaranteeing subsidiaries named therein and Wilmington Trust, National	8-K	07/29/2011	4.1	

	Association (as successor by merger to Wilmington Trust FSB), as trustee and collateral agent, to the Indenture, dated as of May 19, 2010 (as amended or supplemented), among Kratos Defense & Security Solutions, Inc., the guarantors party thereto and Wilmington Trust FSB, as trustee and collateral agent.			
4.9	Form of 10% Senior Secured Note due 2017 (issuable in connection with the 2010 exchange offer).	S-4	06/28/2010	4.1
4.10	Form of 10% Senior Secured Note due 2017 (issuable in connection with the August 2011 exchange offer).	S-4	06/07/2011	4.2
4.11	Form of 10% Senior Secured Note due 2017 (issuable in connection with the October 2011 exchange offer).	S-4	10/25/2011	4.2

47

Table of Contents

Exhibit Number	Exhibit Description	Incorporated by Reference Form	Filing Date/ Period End Date	Exhibit	Filed-Furnished Herewith
4.12	Registration Rights Agreement, dated as of May 19, 2010, by and among Kratos Defense & Security Solutions, Inc., the Guarantors set forth therein, Jefferies & Company, Inc., B. Riley & Co., LLC, Imperial Capital, LLC, Keybanc Capital Markets Inc. and Noble International Investments, Inc.	8-K	05/25/2010	10.4	
4.13	Indenture, dated March 25, 2011, by and among Acquisition Co. Lanza Parent, the Guarantors named therein and a party thereto, and Wilmington Trust FSB, as Trustee and Collateral Agent (including the Form of 10% Senior Secured Notes).	8-K	03/29/2011	4.1	
4.14	First Supplemental Indenture, date April 4, 2011, by and among Kratos Defense & Security Solutions, Inc., Herley Industries, Inc. and Wilmington Trust FSB, as Trustee and Collateral Agent, to the Indenture, dated as of March 25, 2011, among Kratos Defense & Security Solutions, Inc., the Guarantor party thereto and Wilmington Trust FSB, as Trustee and Collateral Agent.	8-K	04/04/2011	4.2	
4.15	Registration Rights Agreement, dated March 25, 2011, by and among Kratos Defense & Security Solutions, Inc., Acquisition Co. Lanza Parent, Lanza Acquisition Co., the Guarantors named therein, Jefferies & Company, Inc., KeyBanc Capital Markets Inc. and Oppenheimer & Co. Inc.	8-K	03/29/2011	4.2	
4.16	Registration Rights Agreement, dated July 27, 2011, by and among Kratos Defense & Security Solutions, Inc., the guarantors named therein, Jefferies & Company, Inc., KeyBanc Capital Markets Inc. and B. Riley & Co., LLC.	8-K	07/29/2011	4.2	
31.1	Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes Oxley Act of 2002.				*
31.2	Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes Oxley Act of 2002.				*

32.1	Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 for Eric M. DeMarco.	*
32.2	Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 for Deanna Lund.	*

Table of Contents

Exhibit Number	Exhibit Description	Incorporated by Reference Form	Filing Date/ Period End Date	Exhibit	Filed-Furnished Herewith
101†	Financial statements from the Quarterly Report on Form 10-Q of Kratos Defense & Security Solutions, Inc. for the quarter ended June 30, 2013, formatted in XBRL: (i) the Condensed Consolidated Balance Sheets, (ii) the Condensed Consolidated Statements of Operations and Comprehensive Income, (iii) the Condensed Consolidated Statements of Cash Flows, (iv) the Notes to the Condensed Consolidated Financial Statements.				*

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

† Pursuant to Rule 406T of Regulation S-T, this interactive data file is deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933, is deemed not filed for purposes of section 18 of the Exchange Act of 1934, and otherwise is not subject to liability under these sections.

Table of Contents

SIGNATURES

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

KRATOS DEFENSE & SECURITY SOLUTIONS, INC.

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

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

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

Date: August 8, 2013