KRATOS DEFENSE & SECURITY SOLUTIONS, INC.
Form 10-Q
November 06, 2015
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

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

For the Quarterly Period Ended September 27, 2015

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

Commission file number 001-34460

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

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

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

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes 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 October 30, 2015, 59,088,317 shares of the registrant’s common stock were outstanding.

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KRATOS DEFENSE & SECURITY SOLUTIONS, INC.

FORM 10-Q

FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 27, 2015

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements.
KRATOS DEFENSE & SECURITY SOLUTIONS, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(in millions, except par value and number of shares)
(Unaudited)

	December 28, 2014	September 27, 2015
Assets		
Current assets:		
Cash and cash equivalents	$33.5	$35.8
Restricted cash	5.4	0.7
Accounts receivable, net	217.5	194.7
Inventoried costs	47.4	54.6
Prepaid expenses	7.1	9.6
Other current assets	10.2	15.0
Current assets of discontinued operations	53.8	—
Total current assets	374.9	310.4
Property, plant and equipment, net	61.6	60.7
Goodwill	483.4	483.4
Intangible assets, net	49.5	39.4
Other assets	32.4	27.6
Non-current assets of discontinued operations	137.0	—
Total assets	$1,138.8	$921.5
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	$44.6	$28.1
Accrued expenses	32.4	26.6
Accrued compensation	41.1	30.0
Accrued interest	5.6	11.8
Billings in excess of costs and earnings on uncompleted contracts	49.6	49.2
Deferred income tax liability	30.3	30.2
Other current liabilities	7.9	9.9
Current liabilities of discontinued operations	14.6	1.5
Total current liabilities	226.1	187.3
Long-term debt principal, net of current portion	622.0	448.5
Line of credit	41.0	—
Other long-term liabilities	24.9	23.9
Non-current liabilities of discontinued operations	0.5	4.2
Total liabilities	914.5	663.9
Commitments and contingencies		
Stockholders' equity:		
Preferred stock, $0.001 par value, 5,000,000 shares authorized, 0 shares outstanding at December 28, 2014 and September 27, 2015	—	—
Common stock, $0.001 par value, 195,000,000 shares authorized; 57,801,978 and 59,085,117 shares issued and outstanding at December 28, 2014 and September 27, 2015, respectively	—	—
Additional paid-in capital	863.4	872.7
Accumulated other comprehensive loss	(1.7)	(1.5)

Accumulated deficit	(637.4)	(613.6)
Total stockholders' equity	224.3	257.6
Total liabilities and stockholders’ equity	$1,138.8	$921.5

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

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

	Three Months Ended		Nine Months Ended	
	September 28, 2014	September 27, 2015	September 28, 2014	September 27, 2015
Service revenues	$97.1	$87.4	$299.5	$263.5
Product sales	93.7	74.3	271.4	216.1
Total revenues	190.8	161.7	570.9	479.6
Cost of service revenues	77.7	65.4	229.7	198.5
Cost of product sales	70.7	55.9	206.9	161.5
Total costs	148.4	121.3	436.6	360.0
Gross profit	42.4	40.4	134.3	119.6
Selling, general and administrative expenses	40.4	34.9	119.3	112.6
Research and development expenses	4.9	3.5	13.6	11.7
Unused office space and other restructuring expenses	0.1	0.4	1.7	1.3
Operating income (loss) from continuing operations	(3.0)	1.6	(0.3)	(6.0)
Other income (expense):				
Interest expense, net	(8.7)	(9.5)	(30.5)	(27.3)
Loss on extinguishment of debt	—	(3.4)	(39.1)	(3.4)
Other income (expense), net	0.2	0.3	0.1	(0.6)
Total other expense, net	(8.5)	(12.6)	(69.5)	(31.3)
Loss from continuing operations before income taxes	(11.5)	(11.0)	(69.8)	(37.3)
Provision (benefit) for income taxes from continuing operations	(0.2)	(15.3)	3.1	(11.1)
Income (loss) from continuing operations	(11.3)	4.3	(72.9)	(26.2)
Discontinued operations (Note 2)				
Income (loss) from operations of discontinued component (including gain on disposal of $80.3 million for the three and nine months ended September 27, 2015)	0.4	77.0	(2.3)	75.0
Income tax expense	—	(26.2)	(0.6)	(25.0)
Income (loss) from discontinued operations	0.4	50.8	(2.9)	50.0
Net income (loss)	$(10.9)	$55.1	$(75.8)	$23.8
Basic income (loss) per common share:				
Net income (loss) from continuing operations	$(0.20)	$0.07	$(1.27)	$(0.45)
Net income (loss) from discontinued operations	0.01	0.86	(0.05)	0.85
Net income (loss) per common share	$(0.19)	$0.93	$(1.32)	$0.40
Diluted income (loss) per common share:				
Net income (loss) from continuing operations	$(0.20)	$0.07	$(1.27)	$(0.45)
Net income (loss) from discontinued operations	0.01	0.85	(0.05)	0.85
Net income (loss) per common share	$(0.19)	$0.92	$(1.32)	$0.40
Weighted average common shares outstanding:				
Basic	57.8	59.0	57.6	58.6
Diluted	57.8	60.0	57.6	58.6

Comprehensive Income (Loss)				
Net income (loss) (from above)	$(10.9)	$55.1	$(75.8)	$23.8
Change in cumulative translation adjustment	(0.1)	0.1	(0.2)	0.2
Comprehensive income (loss)	$(11.0)	$55.2	$(76.0)	$24.0

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

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

	Nine Months Ended			
	September 28, 2014		September 27, 2015	
Operating activities:				
Net income (loss)	$(75.8	)	$23.8	
(Income) loss from discontinued operations	2.9		(50.0	)
Loss from continuing operations	(72.9	)	(26.2	)
Adjustments to reconcile loss from continuing operations to net cash used in operating activities from continuing operations:				
Depreciation and amortization	24.2		19.5	
Stock-based compensation	7.4		5.5	
Deferred income taxes	(0.4	)	3.3	
Amortization of deferred financing costs	2.5		1.5	
Amortization of premium and discount on Senior Secured Notes	(1.1	)	0.9	
Loss on extinguishment of debt	39.1		3.4	
Non-cash income tax benefit	—		(16.1	)
Provision for doubtful accounts	1.2		0.5	
Changes in unused office space accrual	0.2		—	
Changes in assets and liabilities, net of acquisitions:				
Accounts receivable	10.8		22.3	
Inventoried costs	(5.6	)	(9.5	)
Prepaid expenses and other assets	1.3		(4.0	)
Accounts payable	(10.4	)	(17.0	)
Accrued compensation	(7.8	)	(11.2	)
Accrued expenses	(7.9	)	(6.1	)
Advance payments received on contracts	—		2.3	
Accrued interest	11.5		9.4	
Billings in excess of costs and earnings on uncompleted contracts	(6.7	)	(0.3	)
Income tax receivable and payable	2.1		0.3	
Other liabilities	(2.4	)	(1.9	)
Net cash used in operating activities from continuing operations	(14.9	)	(23.4	)
Investing activities:				
Cash paid for acquisitions, net of cash acquired	(2.6	)	—	
Change in restricted cash	(0.1	)	4.7	
Capital expenditures	(8.4	)	(8.1	)
Proceeds from sale of assets	—		0.9	
Net cash used in investing activities from continuing operations	(11.1	)	(2.5	)
Financing activities:				
Proceeds from the issuance of long-term debt	618.5		—	
Extinguishment of long-term debt	(661.5	)	(175.0	)
Debt issuance costs	(8.5	)	—	
Credit agreement borrowings	41.0		—	
Proceeds from the sale of employee stock purchase plan shares	3.9		4.0	
Deferred acquisition payments	—		(0.7	)
Repayment of debt	(0.7	)	(41.7	)
Other	(0.6	)	(0.5	)

Net cash used in financing activities from continuing operations	(7.9)	(213.9)
Net cash flows of continuing operations	(33.9)	(239.8)
Net operating cash flows of discontinued operations	(3.1)	1.9
Net investing cash flows of discontinued operations	(1.0)	240.3
Effect of exchange rate changes on cash and cash equivalents	(0.1)	(0.1)
Net increase (decrease) in cash and cash equivalents	(38.1)	2.3
Cash and cash equivalents at beginning of period	54.2	33.5
Cash and cash equivalents at end of period	$16.1	$35.8

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

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KRATOS DEFENSE & SECURITY SOLUTIONS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

Note 1. Summary of Significant Accounting Policies

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

(a) Basis of Presentation

The information as of September 27, 2015 and for the three and nine months ended September 28, 2014 and September 27, 2015 is unaudited. The condensed consolidated balance sheet as of December 28, 2014 was derived from the Company’s audited consolidated financial statements at that date. In the opinion of management, these unaudited condensed consolidated financial statements include all adjustments, consisting of normal recurring adjustments necessary for a fair presentation of the Company’s financial position, results of operations and cash flows for the interim periods presented. The results have been prepared in accordance with the instructions to Form 10-Q and do not necessarily include all information and footnotes necessary for presentation in accordance with accounting principles generally accepted in the 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 28, 2014, included in the Company’s Annual Report on Form 10-K filed with the U.S. Securities and Exchange Commission (the “SEC”) on March 13, 2015 (the “Form 10-K”). Interim operating results are not necessarily indicative of operating results expected in subsequent periods or for the year as a whole.

As discussed in Note 2 - Discontinued Operations, these condensed consolidated financial statements have been recast for all periods presented to reflect the disposition of the Company's 100% owned subsidiary Herley Industries, Inc. (“Herley”) and certain of Herley’s subsidiaries, including Herley-CTI, Inc., EW Simulation Technology, Ltd. and Stapor Research, Inc. (collectively, the “Herley Entities”) as discontinued operations.

(b) Principles of Consolidation

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

(c) Fiscal Year

The Company has a 52/53 week fiscal year ending on the last Sunday of the calendar year, with interim fiscal periods ending on the last Sunday of each calendar quarter. The three and nine month periods ended September 28, 2014 and September 27, 2015 consisted of 13-week and 39-week periods, respectively. There are 52 calendar weeks in the fiscal years ending on December 28, 2014 and December 27, 2015.

(d) Accounting Estimates

The preparation of condensed consolidated financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the condensed consolidated financial statements and the reported amounts of

revenues and expenses during the reporting period. Such estimates include revenue recognition, allowance for doubtful accounts, warranties, inventory valuation, valuation of long-lived assets including identifiable intangibles and goodwill, accounting for income taxes including the related valuation allowance on the deferred tax asset and uncertain tax positions, contingencies and litigation, contingent acquisition consideration, stock-based compensation, losses on unused office space, and business combination purchase price allocations. In the future, the Company may realize actual results that differ from the current reported estimates. If the estimates that the Company has used change in the future, such changes could have a material impact on the Company's consolidated financial position, results of operations and cash flows.

In accounting for our long-term contracts for production of products and services provided to the U.S. Government within the Kratos Government Solutions (“KGS”) and Unmanned Systems (“US”) segments and provided to our Public Safety & Security (“PSS”) segment customers under fixed price contracts, the Company utilizes both cost-to-cost and units delivered

measures under the percentage-of-completion method of accounting in accordance with the provisions of Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") Topic 605, Revenue Recognition.

Due to the size and nature of many of our contracts accounted for under the percentage-of-completion method of accounting, the estimation of total revenues and costs at completion is complicated and subject to many variables. For example, estimates are made regarding the length of time to complete a contract since costs also include expected increases in wages, prices for materials and allocated fixed costs. Similarly, assumptions are made regarding the future impact of our efficiency initiatives and cost reduction efforts. Incentives, awards or penalties related to performance on contracts are considered in estimating revenue and profit rates and are recorded when there is sufficient information to assess anticipated performance. Suppliers' assertions are also assessed and considered in estimating costs and profit rates.
In determining the fair value of the reporting units, there are key assumptions related to future operating performance and revenue growth. If the actual operating performance and financial results are not consistent with the assumptions used in the determination of the fair value of the reporting units, an impairment of goodwill and long-lived intangibles could occur in future periods. In particular, the US reporting unit fair value includes assumptions that the development of the high performance Unmanned Combat Aerial System ("UCAS") product is successful and the Company is awarded future contracts for the UCAS product. Additionally, the US reporting unit fair value assumes that the Company will receive follow on orders for the Sub-Sonic Aerial Target ("SSAT"), which is currently under contract with the US Navy. The Company may realize actual results that differ from the assumptions used in the determination of the fair value of the reporting units.

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 August 2015, the FASB issued Accounting Standards Update 2015-14 ("ASU 2015-14") Revenue from Contracts with Customers, Deferral of the Effective Date that deferred the effective date of FASB issued Accounting Standards Update 2014-09 ("ASU 2014-09"), Revenue from Contracts with Customers. Pursuant to ASU 2015-14, public business entities, certain not-for-profit entities, and certain employee benefit plans should apply the guidance in ASU 2014-09 to annual reporting periods beginning after December 15, 2017, including interim reporting periods within that reporting period. The FASB issued ASU 2014-09 in May 2014. ASU 2014-09 affects any entity using GAAP that either enters into contracts with customers to transfer goods or services or enters into contracts for the transfer of nonfinancial assets unless those contracts are within the scope of other standards (e.g., insurance contracts or lease contracts). ASU 2014-09 will supersede the revenue recognition requirements in Topic 605, Revenue Recognition, and most industry-specific guidance. ASU 2014-09 also supersedes some cost guidance included in ASC Subtopic 605-35, Revenue Recognition—Construction-Type and Production-Type Contracts. The guidance permits companies to either apply the requirements retrospectively to all prior periods presented or apply the requirements in the year of adoption, through a cumulative adjustment. The Company has not yet selected a transition method nor has it determined the impact of adoption on its condensed consolidated financial statements.
In April 2015, the FASB issued Accounting Standards Update No. 2015-03 ("ASU 2015-03"), Interest - Imputation of Interest (Subtopic 835-30): Simplifying the Presentation of Debt Issuance Costs. ASU 2015-03 requires that debt issuance costs related to a recognized debt liability be presented in the balance sheet as a direct deduction from the carrying amount of that debt liability, consistent with debt discounts. The recognition and measurement guidance for debt issuance costs are not affected by the amendments in ASU 2015-03. The amendments in this ASU are effective

for financial statements issued for fiscal years beginning after December 15, 2015 and interim periods within those fiscal years. The Company does not believe that the adoption of this guidance will have a material impact on its condensed consolidated financial statements.

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

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In August 2014, the FASB issued Accounting Standards Update 2014-15 (“ASU 2014-15”), Presentation of Financial Statements—Going Concern (Subtopic 205-40): Disclosure of Uncertainties about an Entity’s Ability to Continue as a Going Concern. ASU 2014-15 is intended to define management’s responsibility to evaluate whether there is substantial doubt about an organization’s ability to continue as a going concern and to provide related footnote disclosures. Under GAAP, financial statements are prepared under the presumption that the reporting organization will continue to operate as a going concern, except in limited circumstances. Financial reporting under this presumption is commonly referred to as the going concern basis of accounting. The going concern basis of accounting is critical to financial reporting because it establishes the fundamental basis for measuring and classifying assets and liabilities. Currently, GAAP lacks guidance about management’s responsibility to evaluate whether there is substantial doubt about the organization’s ability to continue as a going concern or to provide related footnote disclosures. ASU 2014-15 provides guidance to an organization’s management, with principles and definitions that are intended to reduce diversity in the timing and content of disclosures that are commonly provided by organizations today in the financial statement footnotes. The amendments are effective for annual periods ending after December 15, 2016, including interim periods within that reporting period. Early application is permitted for annual or interim reporting periods for which the financial statements have not previously been issued. The Company does not believe that the adoption of this guidance will have a material impact on its condensed consolidated financial statements.

In April 2014, the FASB issued Accounting Standards Update 2014-08 (“ASU 2014-08”), Presentation of Financial Statements (Topic 205) and Property, Plant, and Equipment (Topic 360): Reporting Discontinued Operations and Disclosures of Disposals of Components of an Entity. The amendments in ASU 2014-08 change the criteria for reporting discontinued operations and require enhanced disclosures in this area. Under the new guidance, only disposals representing a strategic shift in operations should be presented as discontinued operations. Those strategic shifts should have a major effect on the organization’s operations and financial results. Examples include a disposal of a major geographic area, a major line of business, or a major equity method investment. In addition, the new guidance requires expanded disclosures about discontinued operations that will provide financial statement users with more information about the assets, liabilities, income, and expenses of discontinued operations. The new guidance also requires disclosure of the pre-tax income attributable to a disposal of a significant part of an organization that does not qualify for discontinued operations reporting. The amendments in ASU 2014-08 were effective in the first quarter of 2015 for public organizations with calendar year ends. The Company adopted this standard in the quarter ended March 29, 2015. As discussed in Note 2 - Discontinued Operations, the condensed consolidated financial statements set forth in this Form 10-Q have been recast for all periods presented to reflect the disposition of the Herley Entities as discontinued operations.

There have been no changes in the Company's significant accounting policies, other than the adoption of ASU 2014-08, for the three and nine months ended September 27, 2015 as compared to the significant accounting policies described in the Form 10-K.

(f) Fair Value of Financial Instruments

The carrying amounts and the related estimated fair values of the Company's long-term debt financial instruments not measured at fair value on a recurring basis at December 28, 2014 and September 27, 2015 are presented in Note 8. The carrying value of all other financial instruments, including cash equivalents, accounts receivable, accounts payable, accrued expenses, billings in excess of cost and earnings on uncompleted contracts, income taxes payable and short-term debt, approximated their estimated fair values at December 28, 2014 and September 27, 2015 due to the short-term nature of these instruments.

Note 2. Discontinued Operations

On August 21, 2015, the Company completed the sale of the U.S. and U.K. operations of its Electronic Products Division to Ultra Electronics Holdings plc (“Ultra”), a public limited company formed under the laws of England and

Wales and traded on the London Stock Exchange, and Ultra Electronics Defense Inc. (the “Buyer”), a Delaware corporation ultimately owned by Ultra, (the “Transaction”). Pursuant to the terms of that certain Stock Purchase Agreement, dated May 31, 2015, by and among the Company, Ultra and the Buyer (the “Purchase Agreement”), the Company sold to the Buyer all of the issued and outstanding capital stock of its wholly owned subsidiary Herley Industries, Inc. (“Herley”) and certain of Herley’s subsidiaries, including Herley-CTI, Inc., EW Simulation Technology, Ltd. and Stapor Research, Inc. (collectively, the “Herley Entities”), for $260.0 million in cash plus up to $5.0 million for taxes incurred as part of the Transaction, less a $2.0 million escrow to satisfy any purchase price adjustments, and subject to a working capital adjustment of approximately $8.3 million which is expected to be finalized in the fourth quarter of 2015. The Purchase Agreement also contains certain non-compete and indemnification provisions. Under the Purchase Agreement, the Company entered into an agreement to indemnify the Buyer for any pre-acquisition tax liabilities. As a result of this arrangement, the Company recorded amounts that have historically been classified as unrecognized tax benefits into other long term liabilities. The Company also agreed to indemnify Ultra for

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pre-existing environmental conditions for a period of five years from the closing date and with a maximum indemnification payment of $34.0 million. The Company does not believe payments will be required under the indemnification provision, and the assessment of the fair value is immaterial. Under the terms of the Purchase Agreement, a joint 338(h)(10) election has been made for income tax purposes, providing a “step up” in tax basis to Ultra. The Company incurred approximately $11.3 million in transaction-related costs, and expects to incur approximately $8.9 million in federal and state income taxes on the sale. The gain on sale of $80.3 million is subject to changes in the working capital adjustment and indemnification obligations. In accordance with ASC 360-10-45-9, Property, Plant, and Equipment (Topic 360) and ASC 205-20-45-3 Presentation of Financial Statements (Topic 205), the Herley Entities were classified as discontinued operations in the accompanying condensed consolidated financial statements for all periods presented.

Immediately prior to the closing of the transaction, the outstanding shares of the capital stock of (i) General Microwave Corporation, a New York corporation, and its direct and indirect wholly owned subsidiaries General Microwave Israel Corporation, a Delaware corporation, General Microwave Israel (1987) Ltd., an Israeli company, and Herley GMI Eyal Ltd., an Israeli company, (ii) MSI Acquisition Corp., a Delaware corporation and its wholly owned subsidiary Micro Systems, Inc., a Florida corporation, and (iii) Herley-RSS, Inc., a Delaware corporation, were distributed as a dividend by Herley to the Company and will continue their current operations as wholly owned subsidiaries of the Company.

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

	Three Months Ended		Nine Months Ended	
	September 28, 2014	September 27, 2015	September 28, 2014	September 27, 2015
Revenue	$27.3	$11.9	$78.7	$59.7
Cost of sales	16.7	9.0	51.0	40.6
Selling, general and administrative expenses	6.2	3.7	18.1	15.2
Interest expense, net	3.4	2.3	11.7	9.1
Other net expense items that are not major	0.6	0.2	0.2	0.1
Income (loss) from discontinued operations before income taxes	0.4	(3.3)	(2.3)	(5.3)
Gain on disposal of discontinued operations before income taxes	—	80.3	—	80.3
Total gain (loss) on discontinued operations before income taxes	0.4	77.0	(2.3)	75.0
Income tax expense	—	(26.2)	(0.6)	(25.0)
Income (loss) from discontinued operations	$0.4	$50.8	$(2.9)	$50.0

The results for the three and nine months ended September 27, 2015 are through the date of disposal of August 21, 2015.

Depreciation and amortization expense included in selling, general and administrative expenses was $1.6 million and $0.9 million for the three months ended September 28, 2014 and September 27, 2015, respectively, and $5.0 million and $4.2 million for the nine months ended September 28, 2014 and September 27, 2015, respectively.

Interest expense is included based on an allocation consistent with the redemption of $175.0 million of the Company's 7% Senior Secured Notes due 2019 (the “Notes”) and the repayment of $41.0 million in outstanding borrowings on that

certain Credit and Security Agreement, dated May 14, 2014 ("the Credit Agreement"), by and among the Company, the lenders from time to time party thereto, SunTrust Bank, as Agent (the "Agent"), PNC Bank, National Association, as Joint Lead Arranger and Documentation Agent, and SunTrust Robinson Humphrey, Inc., as Joint Leader Arranger and Sole Book Runner, that was repaid upon the completion of the sale of the Herley Entities in accordance with the terms and conditions of the Indenture (as defined below) and the Credit Agreement, respectively. Refer to Note 8 for further discussion.

Intra-period tax allocation rules require the Company to allocate its provision for income taxes between continuing operations and other categories of earnings, such as discontinued operations. In periods in which there is a year-to-date pre-tax loss from continuing operations and pre-tax income in other categories of earnings, such as discontinued operations, the Company must allocate the tax provision to the other categories of earnings. A related tax benefit is then recorded in continuing operations. Due to the net book income in discontinued operations and the intra-period allocation rules, the

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Company recorded income tax expense of $26.2 million and $25.0 million in discontinued operations for the three and nine months ended September 27, 2015, respectively.

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The following is a summary of the assets and liabilities of discontinued operations in the accompanying condensed consolidated balance sheets as of December 28, 2014 and September 27, 2015 (in millions):

	December 28, 2014	September 27, 2015
Cash and cash equivalents	$1.2	$—
Accounts receivable, net	30.7	—
Inventoried costs	20.6	—
Other current assets	1.3	—
Current assets of discontinued operations	$53.8	$—
Property, plant and equipment, net	$21.0	$—
Goodwill	113.0	—
Intangible assets, net	2.8	—
Other assets	0.2	—
Non-current assets of discontinued operations	$137.0	$—
Accounts payable	$3.8	$—
Accrued expenses	1.8	—
Accrued compensation	5.3	0.9
Billings in excess of cost and earnings on uncompleted contracts	2.5	—
Other current liabilities	1.2	0.6
Current liabilities of discontinued operations	$14.6	$1.5
Non-current liabilities of discontinued operations	$0.5	$4.2

Note 3. Goodwill and Intangible Assets

(a) Goodwill

The carrying amounts of goodwill as of December 28, 2014 and September 27, 2015 by reportable segment are as follows (in millions):

	Public Safety & Security	Kratos Government Solutions	Unmanned Systems	Total
Gross value	$53.9	$ 565.8	$111.1	$730.8
Less accumulated impairment	18.3	215.3	13.8	247.4
Net	$35.6	$ 350.5	$97.3	$483.4

In the second quarter of 2015, as a result of the pending disposition of the Herley Entities, the Company performed a valuation analysis to apportion the carrying value of the goodwill of its Electronic Products reportable unit to the retained microwave electronic products business and the Herley Entities held for sale. Accordingly, the allocation of the carrying value of goodwill to the Herley Entities has been included in non-current assets of discontinued operations in the accompanying condensed consolidated balance sheet as of December 28, 2014. The balance allocated to the microwave electronic products business is included in the assets of the KGS segment.

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(b) Purchased Intangible Assets

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

	As of December 28, 2014			As of September 27, 2015		
	Gross Value	Accumulated Amortization	Net Value	Gross Value	Accumulated Amortization	Net Value
Acquired finite-lived intangible assets:						
Customer relationships	$84.1	$(58.2)	$25.9	$84.1	$(65.6)	$18.5
Contracts and backlog	72.1	(69.4)	2.7	72.1	(70.0)	2.1
Developed technology and technical know-how	23.1	(10.9)	12.2	23.1	(12.7)	10.4
Trade names	5.3	(4.6)	0.7	5.3	(4.8)	0.5
Favorable operating lease	1.8	(0.7)	1.1	1.8	(0.8)	1.0
Total finite-lived intangible assets	186.4	(143.8)	42.6	186.4	(153.9)	32.5
Acquired indefinite-lived intangible assets:						
Trade names	6.9	—	6.9	6.9	—	6.9
Total intangible assets	$193.3	$(143.8)	$49.5	$193.3	$(153.9)	$39.4

Consolidated amortization expense related to intangible assets subject to amortization was $14.4 million and $10.1 million for the nine months ended September 28, 2014 and September 27, 2015, 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 include work in process under fixed-price contracts using costs as the basis of the percentage-of-completion calculation under the units of delivery method of revenue recognition. These costs represent accumulated contract costs less the portion of such costs allocated to delivered items. Accumulated contract costs include direct production costs, factory overhead and production tooling costs. Pursuant to contract provisions of U.S. Government contracts, such customers may have title to, or a security interest in, inventories related to such contracts as a result of advances, performance-based payments or progress payments. The Company reflects those advances and payments as an offset against the related inventory balances.

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

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

	December 28, 2014	September 27, 2015
Raw materials	$30.1	$30.4
Work in process	13.3	23.3

Finished goods	2.8	2.6
Supplies and other	2.1	1.6
Subtotal inventoried costs	48.3	57.9
Less: Customer advances and progress payments	(0.9)	(3.3)
Total inventoried costs	$47.4	$54.6

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Note 5. Stockholders' Equity

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

	For the Nine Months Ended	
	September 28, 2014	September 27, 2015
Stockholders' equity at beginning of period	$295.8	$224.3
Comprehensive income (loss):		
Net income (loss)	(75.8)	23.8
Change in cumulative translation adjustment	(0.2)	0.2
Total comprehensive income (loss)	(76.0)	24.0
Exercise of stock options and warrants	(0.1)	—
Stock-based compensation	7.6	5.8
Employee stock purchase plan and restricted stock units settled in cash	3.9	4.0
Restricted stock units traded for taxes	(0.2)	(0.5)
Stockholders' equity at end of period	$231.0	$257.6

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

	September 28, 2014	September 27, 2015
Cumulative translation adjustment	$(0.5)	$(0.5)
Post retirement benefit reserve adjustment net of tax expense	(0.5)	(1.0)
Total accumulated other comprehensive loss	$(1.0)	$(1.5)

There were no reclassifications from other comprehensive loss to net income (loss) for the nine months ended September 28, 2014. There was a reclassification of $0.1 million for the nine months ended September 27, 2015 related to the sale of the Herley Entities.

Common stock issued by the Company for the nine months ended September 28, 2014 and September 27, 2015 was as follows (in millions):

	For the Nine Months Ended	
	September 28, 2014	September 27, 2015
Shares outstanding at beginning of the period	57.1	57.8
Stock issued for employee stock purchase plan, stock options and restricted stock units exercised	0.7	1.3
Shares outstanding at end of the period	57.8	59.1

Note 6. Net Income (Loss) Per Common Share

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

Shares from stock options and awards, excluded from the calculation of diluted net income (loss) per share because their inclusion would have been anti-dilutive, were 0.8 million for the three months ended September 28, 2014 and 0.9 million and 2.1 million for the nine months ended September 28, 2014 and September 27, 2015, respectively.

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Note 7. Income Taxes

A reconciliation of the income tax provision (benefit) from continuing operations computed by applying the statutory federal income tax rate of 35% to income (loss) from continuing operations before income taxes to the income tax provision for the three and nine months ended September 28, 2014 and September 27, 2015 was as follows (in millions):

	For the Three Months Ended		For the Nine Months Ended	
	September 28, 2014	September 27, 2015	September 28, 2014	September 27, 2015
Income tax benefit at federal statutory rate	$(4.0)	$(4.1)	$(24.4)	$(13.0)
State and foreign taxes, net of federal tax benefit and valuation allowance	(0.8)	(2.8)	(0.2)	(2.0)
Nondeductible expenses and other	0.6	(0.3)	1.4	0.5
Impact of deferred tax liabilities for indefinite-lived assets	(0.2)	(0.3)	2.6	3.0
Increase (decrease) in reserves for uncertain tax positions	(3.2)	0.3	(0.2)	0.4
Increase (decrease) in federal valuation allowance	7.4	(8.1)	23.9	—
Total income tax provision (benefit)	$(0.2)	$(15.3)	$3.1	$(11.1)

The tax benefit for the three and nine months ended September 27, 2015 reflects the intra-period tax allocation rules under which a tax benefit is provided in continuing operations to offset a tax provision recorded in discontinued operations.

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

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

In March 2010, an “ownership change” occurred that will limit the utilization of NOL carryforwards. In July 2011, another “ownership change” occurred. The March 2010 ownership change limitation is more restrictive. In prior years, the Company acquired corporations with NOL carryforwards at the date of acquisition (“Acquired NOLs”). The Acquired NOLs are subject to separate limitations that may further restrict the use of Acquired NOLs. As a result, the Company's federal annual utilization of NOL carryforwards will be limited to at least $27.0 million a year for the five years succeeding the March 2010 ownership change and at least $11.6 million for each year thereafter subject to separate limitations for Acquired NOLs. If the entire limitation amount is not utilized in a year, the excess can be carried forward and utilized in future years.

For the nine months ended September 27, 2015, there was no impact of such limitations on the income tax provision, since the amount of taxable income did not exceed the annual limitation amount. In addition, future equity offerings or

acquisitions that have equity as a component of the purchase price could also cause an "ownership change." If and when any other "ownership change" occurs, utilization of the NOL or other tax attributes may be further limited.

As discussed elsewhere, deferred tax assets relating to the NOL and credit carryforwards are offset by a full valuation allowance. In addition, utilization of state tax loss carryforwards is dependent upon sufficient taxable income apportioned to the states. As a result of the Transaction and agreed to section 338(h)10 election, the Company generated a taxable gain which resulted in utilization of a portion of the NOL.

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The Company is subject to taxation in the U.S. and various state and foreign tax jurisdictions. The Company's tax years for 2000 and later are subject to examination by the U.S. and state tax authorities due to the existence of the NOL carryforwards. Generally, the Company's tax years for 2002 and later are subject to examination by various foreign tax authorities.
As of December 28, 2014, the Company had $16.1 million of unrecognized tax benefits that, if recognized, would impact the effective income tax rate for continuing operations, subject to possible offset by an increase in the deferred tax asset valuation allowance. During the nine months ended September 27, 2015, unrecognized tax benefits were increased by $0.3 million relating to various current year and prior positions. As of December 28, 2014, the Company had $0.3 million of unrecognized tax benefits related to discontinued operations. During the nine months ended September 27, 2015, there was a decrease of $0.3 million in unrecognized tax benefits related to discontinued operations due to the disposition of the Herley Entities. In connection with the Company's disposition of the Electronic Products Division, the Company entered into an agreement to indemnify the Buyer for any pre-acquisition tax liabilities. As a result of this arrangement, the Company recorded amounts that have historically been classified as unrecognized tax benefits into other long term liabilities.

The Company recognizes interest and penalties related to unrecognized tax benefits in its provision for income taxes. For the nine months ended September 28, 2014 and September 27, 2015, a $0.1 million expense and $0.2 million expense, respectively, were recorded related to interest and penalties. For the nine months ended September 28, 2014 and September 27, 2015, there was no material benefit recorded related to interest and penalties. The Company believes that no significant amount of the liabilities for uncertain tax positions will expire within twelve months of September 27, 2015.

Note 8. Debt

(a) Issuance of 7% Senior Secured Notes due 2019

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

The Company completed the offering of the Notes in a private placement conducted pursuant to Rule 144A and Regulation S under the Securities Act of 1933, as amended (the "Act"). The Notes are governed by the Indenture, dated May 14, 2014 (the "Indenture"), among the Company, all of the Company's 100% owned domestic subsidiaries (the "Subsidiary Guarantors") and Wilmington Trust, National Association, as Trustee and Collateral Agent. A Subsidiary Guarantor can be released from its Guarantee if (i) all of the Capital Stock (as defined in the Indenture) issued by such Subsidiary Guarantor or all or substantially all of the assets of such Subsidiary Guarantor are sold or otherwise disposed of; (ii) the Company designates such Subsidiary Guarantor as an Unrestricted Subsidiary (as defined in the Indenture); (iii) if the Company exercises its legal defeasance option or its covenant defeasance option; or (iv) upon satisfaction and discharge of the Indenture or payment in full in cash of the principal, premium, if any, accrued and unpaid interest.

The holders of the Notes have a first priority lien on substantially all of the Company's assets and the assets of the Subsidiary 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 Agreement.

The Company pays interest on the Notes semi-annually, in arrears, on May 15 and November 15 of each year.
The Notes include customary covenants and events of default as well as a consolidated fixed charge ratio of 2.0:1 for the incurrence of additional indebtedness. Negative covenants include, among other things, limitations on additional debt, liens, negative pledges, investments, dividends, stock repurchases, asset sales and affiliate transactions. Events of default include, among other events, non-performance of covenants, breach of representations, cross-default to other material debt, bankruptcy, insolvency, material judgments and changes in control. As of September 27, 2015, the Company was in compliance with the covenants contained in the Indenture governing the Notes.

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

On October 16, 2014, the Company exchanged the outstanding Notes for an equal amount of new Notes that have been registered under the Act. The terms of the Notes issued in the exchange offer are identical in all material respects to the terms of the Notes, except the Notes issued in the exchange offer have been registered under the Act.

The terms of the Indenture require that the net cash proceeds from asset dispositions be either utilized to (i) repay or prepay amounts outstanding under the Company's Indenture and Credit Agreement unless such amounts are reinvested in similar collateral, (ii) make an investment in assets that replace the collateral of the Notes or (iii) a combination of both (i) and (ii). To the extent there are any remaining net proceeds from the asset disposition after application of (i) and (ii), such amounts are required to be utilized to repurchase Notes at par after 360 days following the asset disposition.

Following the sale of the Herley Entities (see Note 2), the Company, on August 21, 2015, paid down the $41.0 million outstanding on the Company's $110.0 million Credit Agreement and on September 22, 2015, repurchased $175.0 million of the Notes at par, in accordance with the Indenture.

At September 27, 2015, the Company has approximately $10.0 to $12.0 million of estimated remaining net proceeds that it intends to invest in replacement collateral under the Indenture within the 360 days following the asset disposition.

Related to the $175.0 million repurchase, the Company wrote off $1.8 million of unamortized issue costs, $1.4 million of unamortized discount, and incurred $0.2 million of legal fees, which resulted in a loss on extinguishment of debt of $3.4 million.

As of September 27, 2015, there was $450.0 million in Notes outstanding, and there were no borrowings outstanding on the Credit Agreement.

(b) Other Indebtedness

$110.0 Million Credit Agreement

On May 14, 2014, the Company replaced its credit facility with KeyBank National Association and entered into the Credit Agreement. The Credit Agreement established a five-year senior secured revolving credit facility in the maximum amount of $110.0 million (subject to a potential increase of the maximum principal amount to $135.0 million, subject to the Agent's and applicable lenders' approval as described therein), consisting of a subline for letters of credit in an amount not to exceed $50.0 million, as well as a swingline loan in an aggregate principal amount at any time outstanding not to exceed $10.0 million. The Credit Agreement is secured by a lien on substantially all of the Company's assets and the assets of the guarantors thereunder, subject to certain exceptions and permitted liens. The Credit Agreement has a first priority lien on accounts receivable, inventory, deposit accounts, securities accounts,

cash, securities and general intangibles (other than intellectual property). On all other assets, the Credit Agreement has a second priority lien junior to the lien securing the Notes.

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

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terminated and the principal of, and interest then outstanding on, all of the loans may become immediately due and payable. However, where an event of default arises from certain bankruptcy events, the commitments shall automatically and immediately terminate and the principal of, and interest then outstanding on, all of the loans shall become immediately due and payable.

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

On May 31, 2015, the Company entered into a third amendment (the “Third Amendment”) to the Credit Agreement. Under the terms of the Third Amendment, the definitions of certain terms of the Credit Agreement were modified, the disposition of the Herley Entities was approved by the lenders, a minimum $175.0 million repurchase of the Notes by the Company was required, and the payment in full of the outstanding balance of the Credit Agreement was required. Additionally, the measurement of the fixed charge coverage ratio of 1.15:1 was modified as follows: (i) the fixed charge coverage ratio will not be measured as of the quarterly reporting period ending on or about June 30, 2015, or as of the end of any quarterly reporting period ending after June 30, 2015, if on such date (a) there are no outstanding revolving loans or swingline loans and (b) the aggregate amount outstanding under letters of credit is less than or equal to $17.0 million, and (ii) as to any subsequent quarterly reporting period ending after June 30, 2015, and not covered by (i) above, a fixed charge coverage ratio of at least 1.05:1 will be applied if the percentage of (a) outstanding revolving loans plus the sum of the outstanding swingline loans and outstanding letters of credit that are in excess of $17.0 million, to (b) the revolving credit commitment, minus the Herley Disposition Proceeds Reinvestment Reserve, as defined below, is greater than 0.00% but less than 15.00% or a fixed charge coverage ratio of 1.10:1 will be applied if the aforementioned percentage is equal to or greater than 15.00% but less than 25.00%. In all other instances, the fixed charge coverage ratio remains at 1.15:1. For purposes of computing the fixed charge coverage ratio, consolidated interest expense in connection with the repurchase of Notes with proceeds from the sale of the Herley Entities shall be deemed to have occurred on the first day of the most recently completed four quarterly reporting period.

The terms of the Third Amendment also included the establishment of a reserve (the “Herley Disposition Proceeds Reinvestment Reserve”), that will reduce the maximum facility of $110.0 million. With the sale of the Herley Entities, a $50.8 million reserve was established based upon the collateral carrying value under the Credit Agreement of the Herley Entities disposed. The reserve will be adjusted monthly for the subsequent cumulative reinvestment in similar collateral assets over a period not to exceed 360 days from the sale of the Herley Entities. As of September 27, 2015, the reserve, adjusted for cumulative reinvestment in similar collateral assets since the sale of the Herley Entities was $37.9 million, resulting in a reduced maximum facility of $72.1 million. To the extent that reinvestment occurs in similar collateral assets, the facility will be reinstated accordingly up to a maximum of $110.0 million.

On August 19, 2015, the Company entered into a fourth amendment (the “Fourth Amendment”) to the Credit Agreement. Among other things, the Fourth Amendment provides for a modification of the Third Amendment as it relates to when the minimum fixed charge coverage ratio will be measured based upon the Company’s outstanding

borrowings. Outstanding borrowings for purposes of computing the applicable minimum fixed charge coverage ratio exclude any letter of credit exposure outstanding of $17.0 million plus the amount of letters of credit outstanding for the divested Herley Entities for which a cash deposit has been placed in escrow by the Buyer to cover the amount of such outstanding letters of credit, should the letters of credit be pulled.

As of September 27, 2015, there were no borrowings outstanding on the Credit Agreement and $8.5 million outstanding on letters of credit, resulting in net borrowing base availability of $62.4 million. As discussed above, the maximum facility has been reduced by the collateral sold associated with the Herley Entities. The Company expects to make investments in assets that will replace the collateral which will reinstate the maximum facility to the full $110.0 million. The Company was in compliance with the financial covenants of the Credit Agreement and its amendments as of September 27, 2015.

Debt Acquired in Acquisition

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The Company has a 10-year term loan with a bank in Israel entered into on September 16, 2008 in connection with the acquisition of one of its 100% owned subsidiaries. The balance as of September 27, 2015 was $3.0 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 September 27, 2015.

Fair Value of Long-term Debt

Carrying amounts and the related estimated fair values of the Company’s long-term debt financial instruments not measured at fair value on a recurring basis at December 28, 2014 and September 27, 2015 are presented in the following table:

	As of December 28, 2014			As of September 27, 2015		
$ in millions	Principal	Carrying Amount	Fair Value	Principal	Carrying Amount	Fair Value
Total long-term debt including current portion	$669.8	$664.0	$577.1	$453.0	$449.5	$367.2

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).

The net unamortized original issue discount of $3.5 million as of September 27, 2015, which is the difference between the carrying amount of $449.5 million and the principal amount of $453.0 million presented in the previous table, is being accreted to interest expense over the term of the related debt.

Note 9. Segment Information

The KGS reportable segment is comprised of an aggregation of KGS operating segments, including our microwave electronic products, satellite communications, modular systems and defense and rocket support operating segments. The US reportable segment consists of our unmanned aerial, ground, seaborne and command, control and communications system business. The KGS and US segments provide products, solutions and services for mission critical national security programs. KGS and US customers primarily include national security related agencies, the U.S. Department of Defense (the “DoD”), intelligence agencies and classified agencies, and to a lesser degree, international government agencies and domestic and international commercial customers. The PSS segment designs, engineers, deploys, operates, integrates into command and control infrastructure, maintains and operates security and surveillance solutions for homeland security, public safety, critical infrastructure, government and commercial customers. PSS customers include those in the critical infrastructure, power generation, power transport, nuclear energy, financial, IT, healthcare, education, transportation and petro-chemical industries, as well as certain government and military customers.

The Company organizes its reportable segments based on the nature of the products, solutions and services offered. Transactions between segments are generally negotiated and accounted for under terms and conditions similar to other government and commercial contracts. This presentation is consistent with the Company's operating structure. In the following table total operating income (loss) from continuing operations of the reportable 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 and restricted stock units), the effects of items not considered part of

management's evaluation of segment operating performance, merger and acquisition expenses, corporate costs not allocated to the segments, and other miscellaneous corporate activities.

As discussed in Note 2 - Discontinued Operations, the Company began reporting the Herley Entities as discontinued operations effective in the second quarter of fiscal 2015. Prior to the decision to sell the Herley Entities, the Company reported their financial results in the KGS reportable segment. Accordingly, segment results have been recast for all periods presented to reflect the disposition of the Herley Entities as discontinued operations.

As certain overhead type costs previously allocated to the Herley Entities are not allocable to discontinued operations, prior period corporate costs have been reallocated amongst the continuing reportable segments.

Revenues, depreciation and amortization, and operating income (loss) generated by the Company's reportable segments for the three and nine month periods ended September 28, 2014 and September 27, 2015 are as follows (in millions):

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	Three Months Ended		Nine Months Ended	
	September 28, 2014	September 27, 2015	September 28, 2014	September 27, 2015
Revenues:				
Kratos Government Solutions				
Service revenues	$54.3	$54.3	$157.2	$157.4
Product sales	70.8	54.4	198.0	165.8
Total Kratos Government Solutions	125.1	108.7	355.2	323.2
Public Safety & Security				
Service revenues	42.8	33.1	142.3	106.1
Product sales	—	—	13.0	—
Total Public Safety & Security	42.8	33.1	155.3	106.1
Unmanned Systems				
Service revenues	—	—	—	—
Product sales	22.9	19.9	60.4	50.3
Total Unmanned Systems	22.9	19.9		