KRATOS DEFENSE & SECURITY SOLUTIONS, INC.
Form 10-Q
May 09, 2013
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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 March 31, 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 Smaller reporting company o
(Do not check if a smaller reporting company)

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

As of May 3, 2013, 56,668,864 shares of the registrant's common stock were outstanding.

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KRATOS DEFENSE & SECURITY SOLUTIONS, INC.

FORM 10-Q

FOR THE QUARTERLY PERIOD ENDED MARCH 31, 2013

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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 30, 2012	March 31, 2013
Assets		
Current assets:		
Cash and cash equivalents	$49.0	$51.6
Restricted cash	5.5	5.3
Accounts receivable, net	271.9	281.8
Inventoried costs	94.3	88.2
Prepaid expenses	17.4	18.0
Other current assets	17.3	10.2
Total current assets	455.4	455.1
Property, plant and equipment, net	85.6	84.0
Goodwill	596.4	596.4
Intangible assets, net	106.1	96.8
Other assets	40.4	38.3
Total assets	$1,283.9	$1,270.6
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	$83.6	$71.6
Accrued expenses	46.4	41.7
Accrued compensation	47.8	43.4
Accrued interest	6.3	21.7
Billings in excess of costs and earnings on uncompleted contracts	43.7	48.4
Deferred income tax liability	28.9	29.0
Other current liabilities	22.1	19.8
Total current liabilities	278.8	275.6
Long-term debt principal, net of current portion	629.7	629.5
Long-term debt premium	18.7	17.7
Other long-term liabilities	32.6	32.2
Total liabilities	959.8	955.0
Commitments and contingencies		
Stockholders' equity:		
Preferred stock, $0.001 par value, 5,000,000 shares authorized, 0 shares outstanding at December 30, 2012 and March 31, 2013	—	—
Common stock, $0.001 par value, 195,000,000 shares authorized; 56,613,024 and 56,654,577 shares issued and outstanding at December 30, 2012 and March 31, 2013, respectively	—	—
Additional paid-in capital	847.1	848.8
Accumulated other comprehensive loss	(0.8)	(0.7)
Accumulated deficit	(522.2)	(532.5)
Total stockholders' equity	324.1	315.6
Total liabilities and stockholders' equity	$1,283.9	$1,270.6

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	
	March 25, 2012	March 31, 2013
Service revenues	$102.1	$115.5
Product sales	107.4	137.3
Total revenues	209.5	252.8
Cost of service revenues	79.8	88.2
Cost of product sales	71.9	98.9
Total costs	151.7	187.1
Gross profit	57.8	65.7
Selling, general and administrative expenses	44.2	49.2
Merger and acquisition expenses	0.9	0.1
Research and development expenses	3.6	4.9
Operating income from continuing operations	9.1	11.5
Other income (expense):		
Interest expense, net	(16.1)	(16.2)
Other income (expense), net	0.4	(0.7)
Total other expense, net	(15.7)	(16.9)
Loss from continuing operations before income taxes	(6.6)	(5.4)
Provision (benefit) for income taxes from continuing operations	(4.1)	2.8
Loss from continuing operations	(2.5)	(8.2)
Loss from discontinued operations	(0.5)	(2.1)
Net loss	$(3.0)	$(10.3)
Basic income (loss) per common share:		
Net loss from continuing operations	$(0.08)	$(0.14)
Net loss from discontinued operations	(0.01)	(0.04)
Net loss per common share	$(0.09)	$(0.18)
Diluted income (loss) per common share:		
Net loss from continuing operations	$(0.08)	$(0.14)
Net loss from discontinued operations	(0.01)	(0.04)
Net loss per common share	$(0.09)	$(0.18)
Weighted average common shares outstanding:		
Basic	32.5	56.6
Diluted	32.5	56.6
Comprehensive Loss		
Net loss from above	$(3.0)	$(10.3)
Other comprehensive income:		
Change in cumulative translation adjustment	—	0.1
Other comprehensive income, net of tax	—	0.1
Comprehensive loss	$(3.0)	$(10.2)

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

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

	Three Months Ended	
	March 25, 2012	March 31, 2013
Operating activities:		
Net loss	$(3.0)	$(10.3)
Less: Loss from discontinued operations	(0.5)	(2.1)
Loss from continuing operations	(2.5)	(8.2)
Adjustments to reconcile loss from continuing operations to net cash provided by operating activities from continuing operations:		
Depreciation and amortization	13.6	14.2
Stock-based compensation	1.1	1.9
Amortization of deferred financing costs	1.3	1.3
Amortization of premium on Senior Secured Notes	(1.0)	(1.0)
Provision for doubtful accounts	0.3	0.1
Changes in assets and liabilities, net of acquisitions:		
Accounts receivable	12.9	(9.8)
Inventoried costs	(7.1)	6.3
Prepaid expenses and other assets	(4.9)	—
Accounts payable	6.0	(12.0)
Accrued compensation	0.7	(4.3)
Accrued expenses	(3.7)	(4.7)
Accrued interest payable	15.6	15.3
Billings in excess of costs and earnings on uncompleted contracts	(1.1)	4.9
Income tax receivable and payable	(5.0)	2.9
Other liabilities	(1.2)	(1.8)
Net cash provided by operating activities from continuing operations	25.0	5.1
Investing activities:		
Cash paid for acquisitions, net of cash acquired	(21.5)	1.2
Decrease in restricted cash	0.4	0.2
Capital expenditures	(2.7)	(3.3)
Net cash used in investing activities from continuing operations	(23.8)	(1.9)
Financing activities:		
Repayment of debt	(0.3)	(0.3)
Other	(0.1)	(0.2)
Net cash used in financing activities from continuing operations	(0.4)	(0.5)
Net cash flows of continuing operations	0.8	2.7
Net operating cash flows of discontinued operations	3.9	0.2
Effect of exchange rate changes on cash and cash equivalents	(0.1)	(0.3)
Net increase in cash and cash equivalents	4.6	2.6
Cash and cash equivalents at beginning of period	69.6	49.0
Cash and cash equivalents at end of period	$74.2	$51.6

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

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KRATOS DEFENSE & SECURITY SOLUTIONS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

Note 1. Summary of Significant Accounting Policies

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

(a) Basis of Presentation

The information as of March 31, 2013 and for the three months ended March 25, 2012 and March 31, 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 months ended March 25, 2012 and March 31, 2013 consisted of 13-week periods. 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) Reclassifications

A reclassification was made to the March 25, 2012 condensed consolidated statement of cash flows to present the change in accrued interest of approximately $15.6 million as a discrete line item which has previously been reported in accrued expenses. In addition, a reclassification was made to the March 25, 2012 condensed consolidated statement of operations and comprehensive income (loss) to reclassify approximately $0.4 million of commission expense out of cost of product sales to selling, general and administrative expenses to conform with the March 31, 2013 classification of these expenses.

(e) Accounting Policies and Accounting Standards Updates

In February 2013, the Financial Accounting Standards Board ("FASB") issued "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.

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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 three months ended March 31, 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.

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.

The Company has 10% Senior Secured Notes due 2017 ("the Notes") with an aggregate principal amount of $625.0 million outstanding as of March 31, 2013. The Notes are due on June 1, 2017, and the Company pays interest at the rate of 10% per annum semi-annually, in arrears, on June 1 and December 1 of each year. In addition, the Company has $91.7 million available under its existing revolving credit agreement. See Note 9 for a complete description of the Company's debt.

The Company intends to fund its cash requirements with cash on hand, cash flows from operating activities and borrowings under its existing revolving credit facility. Management believes these sources of liquidity should be sufficient to meet the Company's cash needs for at least the next 12 months. The Company's 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 the Company's control. If the conditions in its industry deteriorate, its customers cancel or postpone projects, its customers experience significant cost constraints as a result of federal budget cuts or sequestration or if the Company is unable to sufficiently increase its revenues or reduce its expenses, the Company may experience, in the future, a significant long-term negative impact to its financial results and cash flows from operations. In such a situation, the Company could fall out of compliance with its financial and other covenants which, if not waived, could limit its liquidity and capital resources.

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 to be paid to the CEI shareholders for the 338(h)(10) election includes $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 will be reduced by $1.0 million to pay the working capital adjustment owed to the Company 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. 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 will pay an estimated $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, which is subject to change based upon the

final fair value of assets acquired and liabilities assumed, will be 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 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 preliminary estimated fair values of the major assets acquired and liabilities assumed (in millions):

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 months ended March 31, 2013 are $25.9 million and $3.2 million, respectively.

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Asset Purchase

On December 30, 2011, the Company acquired selected assets of 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 estimated 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.

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).

In accordance with FASB Accounting Standards Codification ("ASC") Topic 805, Business Combinations (“Topic 805”), the allocation of the purchase price for the Company’s acquisition of CEI is subject to adjustment during the measurement period after the respective closing dates when additional information on asset and liability valuations becomes available. The above estimated fair values of assets acquired and liabilities assumed of CEI are provisional and are based on the information that was available as of the acquisition date to estimate the fair value of assets acquired and liabilities assumed. Measurement period adjustments reflect new information obtained about facts and circumstances that existed as of the acquisition date. The Company believes that such information provides a

reasonable basis for estimating the fair values of assets acquired and liabilities assumed, but the Company is waiting for additional information necessary to finalize those fair values. The Company has not finalized its valuation of certain assets and liabilities recorded in connection with this transaction, including contingent liabilities and deferred taxes. Thus, the provisional measurements recorded are subject to change. Any changes will be recorded as adjustments to the fair value of those assets and liabilities, and residual amounts will be allocated to goodwill. The final valuation adjustments may also require adjustment to the condensed consolidated statements of operations and comprehensive income (loss).

Pro Forma Financial Information

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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 months ended March 31, 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 March 25, 2012
Pro forma revenues	$232.4
Pro forma net loss before tax	(9.4)
Pro forma net loss	(5.3)
Net loss attributable to the registrant	(2.5)
Basic and diluted pro forma loss per share	$(0.09)

The pro forma financial information reflects acquisition related expenses incurred, pro forma adjustments for the additional amortization associated with finite-lived intangible assets acquired, additional incremental interest expense, stock compensation related to the RSUs granted in the CEI transaction, and the related tax expense.

These adjustments are as follows (in millions):

	For the Three Months Ended March 25, 2012
Intangible amortization	$4.0
Net change in stock compensation expense	$0.7
Increase in weighted average common shares outstanding for shares issued and not already included in the weighted average common shares outstanding	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.

Contingent acquisition consideration as of March 31, 2013, which is related to the DEI Services Corporation ("DEI") acquisition, is summarized in the following table (in millions):

Balance as of December 30, 2012	$2.1
Cash payments and adjustments	—
Balance as of March 31, 2013	$2.1

As of March 31, 2013, the $2.1 million of contingent acquisition consideration is reflected in other current liabilities in the condensed consolidated balance sheet.

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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 will be obligated to pay certain additional contingent consideration (the “DEI Contingent Consideration”). The Company has paid $2.9 million related to the DEI Contingent Consideration, of which $2.5 million was paid in April 2012. As of March 31, 2013, the undiscounted amount of future DEI Contingent Consideration that is payable by the Company under the DEI Agreement is $2.1 million, which was paid in April of 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 has 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 first half 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.

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The changes in the carrying amount of goodwill for the three months ended March 31, 2013 are as follows (in millions):

	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 March 31, 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.

(b) Purchased Intangible Assets

The following table sets forth information for finite-lived intangible assets subject to amortization (in millions):

	As of December 30, 2012			As of March 31, 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	$(40.1)	$57.6
Contracts and backlog	80.0	(64.3)	15.7	80.0	(68.6)	11.4
Developed technology and technical know-how	22.1	(6.4)	15.7	22.1	(6.9)	15.2
Trade names	6.1	(1.2)	4.9	6.1	(1.7)	4.4
Favorable operating lease	1.8	(0.4)	1.4	1.8	(0.5)	1.3
Total	$207.7	$(108.5)	$99.2	$207.7	$(117.8)	$89.9

In addition to the finite-lived intangible assets listed in the table above, the Company has $6.9 million of indefinite-lived intangible assets consisting of trade names at both December 30, 2012 and March 31, 2013.

Consolidated amortization expense related to intangible assets subject to amortization was $10.5 million and $9.3 million for the three months ended March 25, 2012 and March 31, 2013.

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):

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	December 30, 2012	March 31, 2013
Raw materials	$48.4	$42.5
Work in process	36.5	39.2
Finished goods	7.3	5.8
Supplies and other	2.2	1.7
Subtotal inventoried costs	94.4	89.2
Less: Customer advances and progress payments	(0.1)	(1.0)
Total inventoried costs	$94.3	$88.2

Note 5. Stockholders' Equity

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

	For the Three Months Ended	
	March 25, 2012	March 31, 2013
Stockholders' equity at beginning of period	$312.6	$324.1
Comprehensive loss:		
Net loss	(3.0)	(10.3)
Foreign currency translation	—	0.1
Total comprehensive loss	(3.0)	(10.2)
Stock-based compensation	1.1	1.9
Restricted stock units traded for taxes	—	(0.2)
Stockholders' equity at end of period	$310.7	$315.6

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

	March 25, 2012	March 31, 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	$(0.2)	$(0.7)

There were no reclassifications from other comprehensive income to net loss for the three months ended March 31, 2013.

Common stock issued by the Company for the three months ended March 25, 2012 and March 31, 2013 was as follows (in millions):

	For the Three Months Ended	
	March 25, 2012	March 31, 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
Shares outstanding at end of the period	32.5	56.7

Note 6. Net Income (Loss) Per Common Share

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

(In millions, except earnings per share)	For the Three Months Ended March 25, 2012	March 31, 2013
Loss from continuing operations (A)	$(2.5)	$(8.2)
Weighted average outstanding shares of common stock (B)	32.5	56.6
Dilutive effect of employee stock options and awards	—	—
Common stock and common stock equivalents (C)	32.5	56.6
Loss per share:		
Basic (A/B)	$(0.08)	$(0.14)
Diluted (A/C)	$(0.08)	$(0.14)

The following shares were excluded from the calculation of diluted loss per share because their inclusion would have been anti-dilutive:

(In millions)	For the Three Months Ended March 25, 2012	March 31, 2013
Shares from stock options and awards	2.8	5.5

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 three months ended March 31, 2013, this amount was increased by $0.1 million and was recorded as an adjustment to goodwill.

The Company recognizes interest and penalties related to unrecognized tax benefits in its provision for income taxes. During the three months ended March 25, 2012, a $0.2 million expense was recorded related to interest and penalties. There was no material expense recorded during the three months ended March 31, 2013. The Company recorded a benefit for interest and penalties related to the reversal of prior positions of $0.1 million for the three months ended March 25, 2012 and no benefit for the three months ended March 31, 2013. The Company believes that it is reasonably possible that as much as $1.5 million of the liabilities for uncertain tax positions will expire within twelve months of March 31, 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 2002 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 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 months ended March 25, 2012 and March 31, 2013 is as follows (in millions):

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	For the Three Months Ended	
	March 25, 2012	March 31, 2013
Income tax benefit at federal statutory rate	$(2.3)	$(1.8)
State and foreign taxes, net of federal tax benefit and valuation allowance	(3.0)	0.9
Nondeductible expenses and other	0.5	0.1
Impact of indefinite lived deferred tax liabilities and state law changes	(1.0)	1.9
Increase/(decrease) in reserves for uncertain tax positions	(0.1)	0.1
Increase/(decrease) in federal valuation allowance	1.8	1.6
Total	$(4.1)	$2.8

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 loss 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. 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 Company's federal annual utilization of NOL carryforwards will be limited to $28.1 million a year for the five years succeeding the initial ownership change in March 2010 and $11.6 million per year thereafter. If the entire limitation amount is not utilized in a year, the excess can be carried forward and utilized in future years. For the three months ended March 31, 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. In addition, utilization of state tax loss carryforwards is dependent upon sufficient taxable income apportioned to the states.

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

	March 25, 2012	March 31, 2013
Revenue	$5.6	$3.6
Net loss before taxes	(0.6)	(2.1)
Provision for income taxes	(0.1)	—
Net loss after taxes	$(0.5)	$(2.1)

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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 March 31, 2013 (in millions):

	December 30, 2012	March 31, 2013
Accounts receivable, net	$3.4	$3.0
Inventoried costs	3.0	0.9
Other current assets	0.2	0.2
Current assets of discontinued operations	6.6	4.1
Other non-current assets	0.4	0.2
Non-current assets of discontinued operations	$0.4	$0.2
Accounts payable and accrued expenses	$4.4	$3.8
Billings in excess of costs and earnings on uncompleted contracts	0.1	0.1
Other current liabilities	0.4	0.3
Current liabilities of discontinued operations	4.9	4.2
Other long-term liabilities	0.3	0.2
Long-term liabilities of discontinued operations	$0.3	$0.2

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 March 31, 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 March 31, 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 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, 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.

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(b) Other Indebtedness

$110.0 Million Credit Facility

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 March 31, 2013, there were no outstanding borrowings on the Amended Revolver and $14.1 million was

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outstanding on letters of credit resulting in net borrowing base availability of $91.7 million. The Company was in compliance with the financial covenants as of March 31, 2013.

Debt Acquired in Acquisition of Herley

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 March 31, 2013 was $5.5 million, and the loan is payable in quarterly installments of $0.3 million plus interest at LIBOR plus a margin of 1.5%. The loan agreement contains various covenants, including a minimum net equity covenant as defined in the loan agreement. The Company was in compliance with all covenants, including the minimum net equity covenant, as of March 31, 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 March 31, 2013 are presented in the following table:

	As of December 30, 2012			As of March 31, 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	$630.5	$648.2	$691.9

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 $17.7 million as of March 31, 2013, which is the difference between the carrying amount of $648.2 million and the principal amount of $630.5 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 March 31, 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 March 31, 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 $140.9 million and $160.7 million or 67% and 64% of total Kratos revenue for the three months ended March 25, 2012 and March 31, 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 next 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

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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. 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 months ended March 25, 2012 and March 31, 2013 are as follows (in millions):

	Three Months Ended	
	March 25, 2012	March 31, 2013
Revenues:		
Kratos Government Solutions		
Service revenues	$61.5	$64.9
Product sales	107.4	137.3
Total Kratos Government Solutions	168.9	202.2
Public Safety & Security		
Service revenues	40.6	50.6
Product sales	—	—
Total Public Safety & Security	40.6	50.6
Total revenues	$209.5	$252.8
Depreciation & amortization:		
Kratos Government Solutions	$12.8	$13.2
Public Safety & Security	0.8	1.0
Total depreciation and amortization	$13.6	$14.2
Operating income:		
Kratos Government Solutions	$9.6	$12.2
Public Safety & Security	1.2	1.2
Unallocated corporate expense, net	(1.7)	(1.9)
Total operating income	$9.1	$11.5

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

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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 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. Either party may appeal the court's decision, which would require the Company to continue to advance payment of indemnifiable costs.

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

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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):

	Three Months Ended	
	March 25, 2012	March 31, 2013
Balance at beginning of the period	$4.3	