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

FORM 10-Q

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

For the Quarterly Period Ended September 28, 2014

☐ **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 ☒ 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 ☒ 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 ☒
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 ☒
As of October 31, 2014, 57,796,295 shares of the registrant's common stock were outstanding.

KRATOS DEFENSE & SECURITY SOLUTIONS, INC.

FORM 10-Q

FOR THE QUARTERLY PERIOD ENDED September 28, 2014

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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 29, 2013	September 28, 2014
Assets		
Current assets:		
Cash and cash equivalents	$ 55.7	$ 16.2
Restricted cash	5.0	5.2
Accounts receivable, net	265.8	255.1
Inventoried costs	74.6	80.4
Prepaid expenses	10.4	9.0
Other current assets	18.8	10.8
Total current assets	430.3	376.7
Property, plant and equipment, net	84.8	82.6
Goodwill	596.4	596.4
Intangible assets, net	69.9	57.8
Other assets	35.2	32.4
Total assets	$ 1,216.6	$ 1,145.9
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	$ 61.9	$ 49.2
Accrued expenses	46.2	37.0
Accrued compensation	44.9	37.1
Accrued interest	5.2	16.7
Billings in excess of costs and earnings on uncompleted contracts	52.5	47.2
Deferred income tax liability	28.4	28.4
Other current liabilities	11.9	11.6
Total current liabilities	251.0	227.2
Long-term debt principal, net of current portion	628.8	621.9
Long-term debt premium	14.5	—
Line of credit	—	41.0
Other long-term liabilities	26.5	24.8
Total liabilities	920.8	914.9
Commitments and contingencies		
Stockholders' equity:		
Preferred stock, $0.001 par value, 5,000,000 shares authorized, 0 shares outstanding at December 29, 2013 and September 28, 2014	—	—
Common stock, $0.001 par value, 195,000,000 shares authorized; 57,056,892 and 57,795,095 shares issued and outstanding at December 29, 2013 and September 28, 2014, respectively	—	—
Additional paid-in capital	856.0	867.2
Accumulated other comprehensive loss	(0.8)	(1.0)
Accumulated deficit	(559.4)	(635.2)
Total stockholders' equity	295.8	231.0
Total liabilities and stockholders' equity	$ 1,216.6	$ 1,145.9

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

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 29, 2013	September 28, 2014	September 29, 2013	September 28, 2014
Service revenues	$ 108.8	$ 97.1	$ 335.0	$ 299.5
Product sales	117.6	120.0	379.9	347.0
Total revenues	226.4	217.1	714.9	646.5
Cost of service revenues	82.4	77.7	254.3	229.7
Cost of product sales	91.7	86.4	282.1	254.8
Total costs	174.1	164.1	536.4	484.5
Gross profit	52.3	53.0	178.5	162.0
Selling, general and administrative expenses	47.8	45.8	144.9	134.1
Merger and acquisition expenses	0.2	—	(2.3)	—
Research and development expenses	4.8	5.9	14.5	17.0
Unused office space and other restructuring	(6.6)	0.1	(5.0)	1.7
Operating income from continuing operations	6.1	1.2	26.4	9.2
Other income (expense):				
Interest expense, net	(16.2)	(12.1)	(48.7)	(42.2)
Loss on extinguishment of debt	—	—	—	(39.1)
Other income (expense), net	0.8	(0.4)	0.2	—
Total other expense, net	(15.4)	(12.5)	(48.5)	(81.3)
Loss from continuing operations before income taxes	(9.3)	(11.3)	(22.1)	(72.1)
Provision (benefit) for income taxes from continuing operations	0.2	(0.2)	2.9	3.7
Loss from continuing operations	(9.5)	(11.1)	(25.0)	(75.8)
Income (loss) from discontinued operations	(0.4)	0.2	(4.8)	—
Net loss	$ (9.9)	$ (10.9)	$ (29.8)	$ (75.8)
Basic and diluted loss per common share:				
Net loss from continuing operations	$ (0.17)	$ (0.19)	$ (0.44)	$ (1.32)
Net loss from discontinued operations	0.00	0.00	(0.08)	0.00
Net loss per common share	$ (0.17)	$ (0.19)	$ (0.52)	$ (1.32)
Basic and diluted weighted average shares outstanding	57.1	57.8	56.7	57.6
Comprehensive Loss				
Net loss from above	$ (9.9)	$ (10.9)	$ (29.8)	$ (75.8)
Change in cumulative translation adjustment	(0.1)	(0.1)	—	(0.2)
Comprehensive loss	$ (10.0)	$ (11.0)	$ (29.8)	$ (76.0)

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

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

	Nine Months Ended	
	September 29, 2013	September 28, 2014
Operating activities:		
Net loss	$ (29.8)	$ (75.8)
Less: Loss from discontinued operations	(4.8)	—
Loss from continuing operations	(25.0)	(75.8)
Adjustments to reconcile loss from continuing operations to net cash provided by (used in) operating activities from continuing operations:		
Depreciation and amortization	40.7	29.2
Stock-based compensation	6.0	7.6
Amortization of deferred financing costs	3.9	2.5
Amortization of premium and discount on Senior Secured Notes	(3.1)	(1.1)
Loss on extinguishment of debt	—	39.1
Provision for doubtful accounts	0.8	1.2
Changes in unused office space accrual	(6.8)	0.2
Changes in assets and liabilities, net of acquisitions:		
Accounts receivable	2.1	9.6
Inventoried costs	10.9	(6.0)
Prepaid expenses and other assets	0.3	0.8
Accounts payable	(26.1)	(12.7)
Accrued compensation	(10.8)	(7.8)
Accrued expenses	(1.5)	(9.2)
Accrued interest payable	15.6	11.5
Billings in excess of costs and earnings on uncompleted contracts	7.5	(7.4)
Income tax receivable and payable	3.9	2.1
Other liabilities	(7.4)	(2.0)
Net cash provided by (used in) operating activities from continuing operations	11.0	(18.2)
Investing activities:		
Cash paid for acquisitions, net of cash acquired	2.2	(2.6)
Proceeds from the sale of discontinued operations	0.4	—
Increase (decrease) in restricted cash	0.5	(0.1)
Capital expenditures	(12.2)	(9.4)
Net cash used in investing activities from continuing operations	(9.1)	(12.1)
Financing activities:		
Proceeds from issuance of long-term debt	—	618.5
Extinguishment of long-term debt	—	(661.5)
Debt issuance costs	—	(8.5)
Credit agreement borrowings	—	41.0
Cash paid for contingent acquisition consideration	(2.1)	—
Repayment of debt	(0.8)	(0.7)
Other	1.2	3.3
Net cash used in financing activities from continuing operations	(1.7)	(7.9)
Net cash flows of continuing operations	0.2	(38.2)
Net operating cash flows of discontinued operations	0.5	(1.2)
Effect of exchange rate changes on cash and cash equivalents	0.1	(0.1)
Net increase (decrease) in cash and cash equivalents	0.8	(39.5)
Cash and cash equivalents at beginning of period	49.0	55.7
Cash and cash equivalents at end of period	$ 49.8	$ 16.2

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

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 28, 2014 and for the three and nine months ended September 29, 2013 and September 28, 2014 is unaudited. The condensed consolidated balance sheet as of December 29, 2013 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 United States ("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 29, 2013, included in the Company's Annual Report on Form 10-K filed with the U.S. Securities and Exchange Commission ("SEC") on March 12, 2014 (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 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 29, 2013 and September 28, 2014 consisted of 13-week and 39-week periods, respectively. There are 52 calendar weeks in the fiscal years ending on December 29, 2013 and December 28, 2014.

(d) Accounting Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Such estimates include revenue recognition, allowance for doubtful accounts, warranties, inventory valuation, valuation of long-lived assets including identifiable intangibles and goodwill, accounting for income taxes including the related valuation allowance on the deferred tax asset and uncertain tax positions, contingencies and litigation, contingent acquisition consideration, stock-based compensation, 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 and provided to our Public Safety & Security ("PSS") segment customers under fixed price contracts, we utilize 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.

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 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 the ASU 2014-08 change the criteria for reporting discontinued operations and requires 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 are effective in the first quarter of 2015 for public organizations with calendar year ends. Early adoption is permitted. The Company does not believe that the adoption of this guidance will have a material impact on its condensed consolidated financial statements.

In May 2014, the FASB issued Accounting Standards Update 2014-09 ("ASU 2014-09") "Revenue from Contracts with Customers". 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. The ASU also supersedes some cost guidance included in ASC Subtopic 605-35, *Revenue Recognition—Construction-Type and Production-Type Contracts*. For a public entity, the amendments in this ASU are effective for annual reporting periods beginning after December 15, 2016, including interim periods within that reporting period. Early application is not permitted. 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 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.

There have been no changes in the Company's significant accounting policies for the nine months ended September 28, 2014 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 29, 2013 and September 28, 2014 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 29, 2013 and September 28, 2014 due to the short-term nature of these instruments.

Note 2. Goodwill and Intangible Assets

(a) Goodwill

The carrying amounts of goodwill as of December 29, 2013 and September 28, 2014 by reportable segment are as follows (in millions):

	Public Safety & Security	Kratos Government Solutions	Total
Gross value	$ 53.9	$ 789.9	$ 843.8
Less accumulated impairment	18.3	229.1	247.4
Net	$ 35.6	$ 560.8	$ 596.4

(b) Purchased Intangible Assets

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

	As of December 29, 2013			As of September 28, 2014		
	Gross Value	Accumulated Amortization	Net Value	Gross Value	Accumulated Amortization	Net Value
Acquired finite-lived intangible assets:						
Customer relationships	$ 97.7	$ (53.7)	$ 44.0	$ 99.0	$ (66.5)	$ 32.5
Contracts and backlog	80.0	(78.7)	1.3	82.7	(79.7)	3.0
Developed technology and technical know-how	22.1	(8.6)	13.5	23.1	(10.3)	12.8
Trade names	6.1	(3.1)	3.0	6.1	(4.6)	1.5
Favorable operating lease	1.8	(0.6)	1.2	1.8	(0.7)	1.1
Total finite-lived intangible assets	207.7	(144.7)	63.0	212.7	(161.8)	50.9
Acquired indefinite-lived intangible assets:						
Trade names	6.9	—	6.9	6.9	—	6.9
Total intangible assets	$ 214.6	$ (144.7)	$ 69.9	$ 219.6	$ (161.8)	$ 57.8

Consolidated amortization expense related to intangible assets subject to amortization was $9.0 million and $5.7 million for the three months ended September 29, 2013 and September 28, 2014, respectively, and $27.3 million and $17.0 million for the nine months ended September 29, 2013 and September 28, 2014, respectively.

Note 3. 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 29, 2013	September 28, 2014
Raw materials	$ 44.5	$ 43.4
Work in process	24.3	32.1
Finished goods	4.6	4.4
Supplies and other	1.9	2.4
Subtotal inventoried costs	75.3	82.3
Less: Customer advances and progress payments	(0.7)	(1.9)
Total inventoried costs	$ 74.6	$ 80.4

Note 4. Stockholders' Equity

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

	For the Nine Months Ended	
	September 29, 2013	September 28, 2014
Stockholders' equity at beginning of period	$ 324.1	$ 295.8
Comprehensive loss:		
Net loss	(29.8)	(75.8)
Foreign currency translation	—	(0.2)
Total comprehensive loss	(29.8)	(76.0)
Exercise of stock options and warrants	—	(0.1)
Stock-based compensation	6.0	7.6
Employee stock purchase plan and restricted stock units settled in cash	1.6	3.9
Restricted stock units traded for taxes	(0.2)	(0.2)
Stockholders' equity at end of period	$ 301.7	$ 231.0

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

	September 29, 2013	September 28, 2014
Cumulative translation adjustment	$ (0.3)	$ (0.5)
Post retirement benefit reserve adjustment net of tax expense	(0.5)	(0.5)
Total accumulated other comprehensive loss	$ (0.8)	$ (1.0)

There were no reclassifications from other comprehensive income to net loss for the three and nine months ended September 29, 2013 or September 28, 2014.

Common stock issued by the Company for the nine months ended September 29, 2013 and September 28, 2014 was as follows (in millions):

	For the Nine Months Ended	
	September 29, 2013	September 28, 2014
Shares outstanding at beginning of the period	56.6	57.1
Stock issued for employee stock purchase plan, stock options and restricted stock units exercised	0.4	0.7
Shares outstanding at end of the period	57.0	57.8

Note 5. 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 loss per share because their inclusion would have been anti-dilutive, were 1.9 million and 0.8 million for the three months ended September 29, 2013 and September 28, 2014, respectively, and 2.7 million and 0.9 million for the nine months ended September 29, 2013 and September 28, 2014, respectively.

Note 6. Income Taxes

A reconciliation of the total income tax provision (benefit), computed by applying the statutory federal income tax rate of 35% to loss from continuing operations before income tax provision, to the total income tax provision (benefit) for the three and nine months ended September 29, 2013 and September 28, 2014 is as follows (in millions):

	For the Three Months Ended		For the Nine Months Ended	
	September 29, 2013	September 28, 2014	September 29, 2013	September 28, 2014
Income tax benefit at federal statutory rate	$ (3.3)	$ (3.9)	$ (7.7)	$ (25.2)
State and foreign taxes, net of federal tax benefit and valuation allowance	—	(0.7)	1.6	0.1
Nondeductible expenses and other	—	0.5	0.4	1.3
Impact of deferred tax liabilities for indefinite-lived assets	0.2	(0.2)	2.9	2.9
Decrease in reserves for uncertain tax positions	(0.1)	(3.2)	(1.7)	(0.1)
Increase in federal valuation allowance	3.4	7.3	7.4	24.7
Total income tax provision (benefit)	$ 0.2	$ (0.2)	$ 2.9	$ 3.7

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 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 three and nine months ended September 28, 2014, 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.

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 29, 2013, the Company had $15.8 million of unrecognized tax benefits that, if recognized, would impact the effective income tax rate, subject to possible offset by an increase in the deferred tax asset valuation allowance. During the nine months ended September 28, 2014, unrecognized tax benefits were decreased by $0.2 million relating to various current year and prior positions.

The Company recognizes interest and penalties related to unrecognized tax benefits in its provision for income taxes. During the nine months ended September 28, 2014 and September 29, 2013, a $0.1 million expense was recorded related to interest and penalties. The Company recorded a benefit for interest and penalties related to the reversal of prior position of $0.2 million for the nine months ended September 29, 2013. There was no material benefit recorded for the nine months ended September 28, 2014. The Company believes that no significant amount of the liabilities for uncertain tax positions will expire within twelve months of September 28, 2014.

Note 7. Discontinued Operations

In June 2012, consistent with its plans to complete an 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 Kratos Government Solutions ("KGS") segment, and in accordance with ASC Topic 205, *Presentation of Financial Statements (*"Topic 205"*)*, these businesses were classified as held for sale and reported in discontinued operations in the accompanying condensed consolidated financial statements.

In the second quarter of 2012, the Company recorded a $1.5 million impairment charge associated with the portion of goodwill that was allocated to the discontinued businesses based on management's estimate of the fair value of the business. The Company sold its domestic operations to two buyers for approximately $0.8 million in cash consideration and the assumption of certain liabilities. The Company received $0.3 million in cash in 2012 from the first buyer and $0.5 million in cash in April 2013 from the second buyer. The Company recorded a $1.2 million impairment charge in the first quarter of 2013 related to its revised estimate of the fair value of these operations.

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

	For the Three Months Ended		For the Nine Months Ended	
	September 29, 2013	September 28, 2014	September 29, 2013	September 28, 2014
Revenue	$ —	$ —	$ 3.6	$ —
Net income (loss) before taxes	$ (0.4)	$ 0.2	$ (4.8)	$ —

The following is a summary of the liabilities of discontinued operations, which are in other current liabilities and other long-term liabilities in the accompanying condensed consolidated balance sheets as of December 29, 2013 and September 28, 2014 (in millions):

	December 29, 2013	September 28, 2014
Accounts payable and accrued expenses	$ 1.1	$ 0.8
Other current liabilities	1.4	0.8
Current liabilities of discontinued operations	$ 2.5	$ 1.6
Other long-term liabilities	$ 0.2	$ —

Note 8. Debt

(a) Issuance of 7.00% 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 newly issued 7.00% Senior Secured Notes due in 2019 (the "7% Notes"). The net proceeds of the 7% Notes was $618.5 million after an original issue discount of $6.5 million. The Company incurred debt issuance costs of $8.6 million associated with the new 7% Notes. The Company utilized the net proceeds from the 7% Notes, a $41.0 million draw on a new 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 7.00% Notes (hereafter 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 an Indenture dated May 14, 2014 (the “Indenture”) among the Company, certain of the Company’s subsidiaries (the “Guarantors”) and Wilmington Trust, National Association, as Trustee and Collateral Agent. A Guarantor can be released from its Guarantee if (a) all of the Capital Stock issued by such Guarantor or all or substantially all of the assets of such Guarantor are sold or otherwise disposed of; (b) the Company designates such Guarantor as an Unrestricted Subsidiary; (c) if the Company exercises its legal defeasance option or its covenant defeasance option; (d) upon satisfaction and discharge of the Indenture or payment in full in cash of the principal of, 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 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 new $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 28, 2014, the Company was in compliance with the covenants contained in the Indenture governing the Notes.

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 September 17, 2014, the Company commenced an offer to exchange the outstanding Notes for an equal amount of new 7.00% Senior Secured Notes due 2019 (the “Exchange Notes”) that have been registered under the Securities Act of 1933, as amended. The Company made the exchange offer pursuant to the terms of the Registration Rights Agreement, dated May 14, 2014, that it entered into with the Guarantors and the representative of the initial purchasers of the Notes. The purpose of the exchange offer was to allow holders of the Notes to exchange their Notes for Exchange Notes that are not subject to transfer restrictions. The terms of the Exchange Notes are identical in all material respects to the terms of the Notes, except the Exchange Notes have been registered under the Securities Act. The Exchange Notes are fully and unconditionally guaranteed, jointly and severally, on a senior secured basis by the Company and each of its subsidiaries, as the guarantors thereof. The Company pays interest on the Exchange Notes semi-annually, in arrears, on May 15 and November 15 of each year. The Company completed the exchange offer on October 16, 2014, at which time the holders of all outstanding Notes had elected to exchange their Notes for Exchange Notes. The Company has no further obligations under the Registration Rights 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 a Credit and Security Agreement (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 Lead Arranger and Sole Book Runner. The Credit Agreement establishes 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 places limits on other various payments, as well as a financial covenant relating to a minimum fixed charge coverage ratio of 1.15:1. 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 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. As of September 28, 2014, there was $41.0 million outstanding on the Credit Agreement and $12.4 million was outstanding on letters of credit, resulting in net borrowing base availability of $43.3 million. The Company was in compliance with the financial covenants of the Credit Agreement as of September 28, 2014.

Debt Acquired in Acquisition

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 wholly owned subsidiaries. The balance as of September 28, 2014 was $4.0 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 28, 2014.

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 29, 2013 and September 28, 2014 are presented in the following table:

	As of December 29, 2013			As of September 28, 2014		
$ in millions	**Principal**	**Carrying Amount**	**Fair Value**	**Principal**	**Carrying Amount**	**Fair Value**
Total Long-term debt including current portion	$ 629.8	$ 644.3	$ 679.7	$ 670.0	$ 663.9	$ 671.0

The fair value of the Company's long-term debt as of December 29, 2013 was based upon actual trading activity (Level 1, Observable inputs that reflect quoted prices in active markets). The fair value of the Company's long-term debt as of September 28, 2014 was based upon broker reported trading activity by sophisticated investors (Level 2, Quoted prices in markets that are not active). The fair value at both December 29, 2013 and September 28, 2014 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 original issue discount of $6.1 million as of September 28, 2014, which is the difference between the carrying amount of $663.9 million and the principal amount of $670.0 million presented in the previous table, is being accreted to interest expense over the term of the related debt.

Note 9. Segment Information

The Company operates in two principal reportable business segments: Kratos Government Solutions ("KGS") and Public Safety & Security ("PSS"). The Company organizes its reportable business segments based on the nature of the products, solutions and services offered, the nature of the production processes, the type or class of customer for their products and services, the methods used to distribute their products or provide their services, and the nature of the regulatory environment. The KGS reportable business segment has five operating segments: Defense Rocket Support Services, Electronic Products, Technical and Training Solutions, Modular Systems, and Unmanned Systems. All of the KGS operating divisions provide technology based defense solutions, involving products and services, primarily for mission critical United States National Security priorities, with the primary focus relating to the nation's C5ISR requirements. The PSS reportable business segment provides integrated solutions for advanced homeland security, public safety, critical infrastructure security, and security and surveillance systems for government, industrial and commercial customers.

Revenues, depreciation and amortization, and operating income generated by the Company's reportable segments for the three and nine month periods ended September 29, 2013 and September 28, 2014 are as follows (in millions):

	Three Months Ended		Nine Months Ended	
	September 29, 2013	September 28, 2014	September 29, 2013	September 28, 2014
Revenues:				
Kratos Government Solutions				
Service revenues	$ 57.0	$ 54.3	$ 180.9	$ 157.2
Product sales	117.6	120.0	379.9	334.0
Total Kratos Government Solutions	174.6	174.3	560.8	491.2
Public Safety & Security				
Service revenues	51.8	42.8	154.1	142.3
Product sales	—	—	—	13.0
Total Public Safety & Security	51.8	42.8	154.1	155.3
Total revenues	$ 226.4	$ 217.1	$ 714.9	$ 646.5
Depreciation & amortization:				
Kratos Government Solutions	$ 12.1	$ 9.4	$ 38.0	$ 27.7
Public Safety & Security	0.8	0.5	2.7	1.5
Total depreciation and amortization	$ 12.9	$ 9.9	$ 40.7	$ 29.2
Operating income:				
Kratos Government Solutions	$ 6.4	$ 8.2	$ 23.8	$ 17.6
Public Safety & Security	1.8	(4.1)	5.7	(0.1)
Unallocated corporate expense, net	(2.1)	(2.9)	(3.1)	(8.3)
Total operating income	$ 6.1	$ 1.2	$ 26.4	$ 9.2

Total operating income 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, 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.

Note 10. 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 $143.4 million and $139.1 million, or 63% and 64% of total Kratos revenue, for the three months ended September 29, 2013 and September 28, 2014, respectively, and approximately $460.9 million and $378.4 million, or 64% and 59% of total revenue, for the nine months ended September 29, 2013 and September 28, 2014, respectively.

Note 11. 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 condensed consolidated financial statements. An estimated loss contingency is accrued in the Company's condensed consolidated financial statements if it is probable that a liability has been incurred and the amount of the loss can be reasonably estimated. Because litigation and legal matters are inherently unpredictable and unfavorable resolutions could occur, assessing litigation and legal matter 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 condensed consolidated financial statements; and the unique facts and circumstances of the particular matter that may give rise to additional factors.

Regulatory Matters

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. The Company reviews such accruals on a quarterly basis for sufficiency based on the most recent information available. Based on its assessment, the Company 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. We intend to defend ourselves in any such matters and do not currently believe that the outcome of any such matters will have a material adverse impact on our financial condition, results of operations or cash flows.

(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):

	Nine Months Ended	
	September 29, 2013	September 28, 2014
Balance at beginning of the period	$ 5.2	$ 5.4
Costs accrued and revenues deferred	0.3	0.6
Settlements made (in cash or kind) and revenues recognized and other	(0.6)	(0.5)
Balance at end of period	4.9	5.5
Less: Current portion	(4.6)	(5.1)
Non-current accrued product warranty and deferred warranty revenue	$ 0.3	$ 0.4

Note 12. Condensed Consolidating Financial Statements

The Company has $625.0 million in outstanding Senior Secured Notes (see Note 8). The Notes are guaranteed by all of the Company's 100% owned domestic subsidiaries (the "Subsidiary Guarantors") and are collateralized by the assets of all of the Company's 100% owned subsidiaries. The Notes are fully and unconditionally guaranteed on a joint and several basis by each Subsidiary Guarantor and the Company. There are no contractual restrictions limiting cash transfers from Subsidiary Guarantors by dividends, loans or advances to the Company. The Senior Secured Notes are not guaranteed by the Company's foreign subsidiaries (the “Non-Guarantor Subsidiaries”).

The following tables present condensed consolidating financial statements for the parent company, the Subsidiary Guarantors and the Non-Guarantor Subsidiaries, respectively. The condensed consolidating financial information below follows the same accounting policies as described in the condensed consolidated financial statements, except for the use of the equity method of accounting to reflect ownership interests in 100% owned subsidiaries, which are eliminated upon consolidation. Subsequent to the issuance of the Company’s condensed consolidated financial statements for the quarter ended September 29, 2013, the Company reclassified cash flows related to Investment in affiliated companies to a separate line item in its Condensed Consolidating Statement of Cash Flows. These amounts were previously combined with financings from affiliated companies. There was no total impact on cash flow from either investing or financing activities.

Condensed Consolidating Balance Sheet
December 29, 2013
(Unaudited)
(in millions)

	Parent Company	Guarantors on a Combined Basis	Non-Guarantors on a Combined Basis	Eliminations	Consolidated
Assets					
Current Assets:					
Cash and cash equivalents	$ 42.7	$ (3.0)	$ 16.0	$ —	$ 55.7
Accounts receivable, net	—	238.6	27.2	—	265.8
Amounts due from affiliated companies	410.2	—	—	(410.2)	—
Inventoried costs	—	59.1	15.5	—	74.6
Other current assets	10.7	19.4	4.1	—	34.2
Total current assets	463.6	314.1	62.8	(410.2)	430.3
Property, plant and equipment, net	2.1	71.9	10.8	—	84.8
Goodwill	—	574.8	21.6	—	596.4
Intangible assets, net	—	68.5	1.4	—	69.9
Investment in subsidiaries	474.2	36.7	—	(510.9)	—
Amounts due from affiliated companies	—	24.0	—	(24.0)	—
Other assets	12.9	23.0	(0.7)	—	35.2
Total assets	$ 952.8	$ 1,113.0	$ 95.9	$ (945.1)	$ 1,216.6
Liabilities and Stockholders' Equity					
Current liabilities:					
Accounts payable	$ 2.8	$ 54.1	$ 5.0	$ —	$ 61.9
Accrued expenses	6.6	40.9	3.9	—	51.4
Accrued compensation	4.0	36.9	4.0	—	44.9
Billings in excess of costs and earnings on uncompleted contracts	—	45.4	7.1	—	52.5
Deferred income tax liability	—	28.4	—	—	28.4
Amounts due to affiliated companies	—	390.2	20.0	(410.2)	—
Other current liabilities	1.3	9.5	1.1	—	11.9
Total current liabilities	14.7	605.4	41.1	(410.2)	251.0
Long-term debt, net of current portion	639.5		3.8	—	643.3
Amounts due to affiliated companies	—	—	24.0	(24.0)	—
Other long-term liabilities	2.8	21.4	2.3	—	26.5
Total liabilities	657.0	626.8	71.2	(434.2)	920.8
Total stockholders' equity	295.8	486.2	24.7	(510.9)	295.8
Total liabilities and stockholders' equity	$ 952.8	$ 1,113.0	$ 95.9	$ (945.1)	$ 1,216.6

Condensed Consolidating Balance Sheet
September 28, 2014
(Unaudited)
(in millions)

	Parent Company	Guarantors on a Combined Basis	Non-Guarantors on a Combined Basis	Eliminations	Consolidated
Assets					
Current Assets:					
Cash and cash equivalents	$ 13.7	$ (5.9)	$ 8.4	$ —	$ 16.2
Accounts receivable, net	—	223.7	31.4	—	255.1
Amounts due from affiliated companies	398.1	—	—	(398.1)	—
Inventoried costs	—	61.7	18.7	—	80.4
Other current assets	5.0	16.1	3.9	—	25.0
Total current assets	416.8	295.6	62.4	(398.1)	376.7
Amounts due from affiliated companies, long-term	—	24.0	—	(24.0)	—
Property, plant and equipment, net	2.0	70.3	10.3	—	82.6
Goodwill	—	572.4	24.0	—	596.4
Intangible assets, net	—	57.4	0.4	—	57.8
Investment in subsidiaries	492.2	41.9	—	(534.1)	—
Other assets	7.9	24.5	—	—	32.4
Total assets	$ 918.9	$ 1,086.1	$ 97.1	$ (956.2)	$ 1,145.9
Liabilities and Stockholders' Equity					
Current liabilities:					
Accounts payable	$ 3.2	$ 41.9	$ 4.1	$ —	$ 49.2
Accrued expenses	17.4	32.2	4.1	—	53.7
Accrued compensation	4.1	29.4	3.6	—	37.1
Billings in excess of costs and earnings on uncompleted contracts	—	40.9	6.3	—	47.2
Deferred income tax liability	(0.8)	29.2	—	—	28.4
Amounts due to affiliated companies	—	379.2	18.9	(398.1)	—
Other current liabilities	1.0	9.6	1.0	—	11.6
Total current liabilities	24.9	562.4	38.0	(398.1)	227.2
Long-term debt, net of current portion	659.9	—	3.0	—	662.9
Amounts due to affiliated companies	—	—	24.0	(24.0)	—
Other long-term liabilities	3.1	19.5	2.2	—	24.8
Total liabilities	687.9	581.9	67.2	(422.1)	914.9
Total stockholders' equity	231.0	504.2	29.9	(534.1)	231.0
Total liabilities and stockholders' equity	$ 918.9	$ 1,086.1	$ 97.1	$ (956.2)	$ 1,145.9

Condensed Consolidating Statement of Operations and Comprehensive Income (Loss)
Three Months Ended September 29, 2013
(Unaudited)
(in millions)

	Parent Company	Guarantors on a Combined Basis	Non-Guarantors on a Combined Basis	Eliminations	Consolidated
Service revenues	$ —	$ 107.6	$ 1.2	$ —	$ 108.8
Product sales	—	103.9	17.5	(3.8)	117.6
Total revenues	—	211.5	18.7	(3.8)	226.4
Cost of service revenues	—	81.7	0.7	—	82.4
Cost of product sales	—	82.2	13.3	(3.8)	91.7
Total costs	—	163.9	14.0	(3.8)	174.1
Gross profit	—	47.6	4.7	—	52.3
Selling, general and administrative expenses	1.4	36.2	3.8	—	41.4
Research and development expenses	—	4.7	0.1	—	4.8
Operating income (loss) from continuing operations	(1.4)	6.7	0.8	—	6.1
Other income (expense):					
Interest expense, net	(16.2)	0.1	(0.1)	—	(16.2)
Other income (expense), net	—	0.2	0.6	—	0.8
Total other income and expense, net	(16.2)	0.3	0.5	—	(15.4)
Income (loss) from continuing operations before income taxes	(17.6)	7.0	1.3	—	(9.3)
Provision (benefit) for income taxes from continuing operations	—	(0.1)	0.3	—	0.2
Income (loss) from continuing operations	(17.6)	7.1	1.0	—	(9.5)
Loss from discontinued operations	—	(0.4)	—	—	(0.4)
Equity in net income (loss) of subsidiaries	7.7	1.0	—	(8.7)	—
Net income (loss)	$ (9.9)	$ 7.7	$ 1.0	$ (8.7)	$ (9.9)
Comprehensive income (loss)	$ (10.0)	$ 7.7	$ 0.9	$ (8.6)	$ (10.0)

Condensed Consolidating Statement of Operations and Comprehensive Income (Loss)
Three Months Ended September 28, 2014
(Unaudited)
(in millions)

	Parent Company	Guarantors on a Combined Basis	Non-Guarantors on a Combined Basis	Eliminations	Consolidated
Service revenues	$ —	$ 94.1	$ 3.0	$ —	$ 97.1
Product sales	—	103.4	18.6	(2.0)	120.0
Total revenues	—	197.5	21.6	(2.0)	217.1
Cost of service revenues	—	75.4	2.3	—	77.7
Cost of product sales	—	76.9	11.5	(2.0)	86.4
Total costs	—	152.3	13.8	(2.0)	164.1
Gross profit	—	45.2	7.8	—	53.0
Selling, general and administrative expenses	2.9	39.5	3.5	—	45.9
Research and development expenses	—	5.5	0.4	—	5.9
Operating income (loss) from continuing operations	(2.9)	0.2	3.9	—	1.2
Other income (expense):					
Interest expense, net	(12.2)	—	0.1	—	(12.1)
Loss on extinguishment of debt	—	—	—	—	—
Other income (expense), net	—	0.1	(0.5)	—	(0.4)
Total other income and expense, net	(12.2)	0.1	(0.4)	—	(12.5)
Income (loss) from continuing operations before income taxes	(15.1)	0.3	3.5	—	(11.3)
Provision (benefit) for income taxes from continuing operations	0.4	(1.2)	0.6	—	(0.2)
Income (loss) from continuing operations	(15.5)	1.5	2.9	—	(11.1)
Income (loss) from discontinued operations	0.2	—	—	—	0.2
Equity in net income (loss) of subsidiaries	4.4	2.9	—	(7.3)	—
Net income (loss)	$ (10.9)	$ 4.4	$ 2.9	$ (7.3)	$ (10.9)
Comprehensive income (loss)	$ (11.0)	$ 4.4	$ 2.8	$ (7.2)	$ (11.0)

Condensed Consolidating Statement of Operations and Comprehensive Income (Loss)
Nine Months Ended September 29, 2013
(Unaudited)
(in millions)

	Parent Company	Guarantors on a Combined Basis	Non-Guarantors on a Combined Basis	Eliminations	Consolidated
Service revenues	$ —	$ 332.4	$ 2.6	$ —	$ 335.0
Product sales	—	338.1	55.1	(13.3)	379.9
Total revenues	—	670.5	57.7	(13.3)	714.9
Cost of service revenues	—	252.5	1.8	—	254.3
Cost of product sales	—	255.7	39.7	(13.3)	282.1
Total costs	—	508.2	41.5	(13.3)	536.4
Gross profit	—	162.3	16.2	—	178.5
Selling, general and administrative expenses	5.1	122.4	10.1	—	137.6
Research and development expenses	—	13.7	0.8	—	14.5
Operating income (loss)from continuing operations	(5.1)	26.2	5.3	—	26.4
Other income (expense):					
Interest expense, net	(48.4)	0.1	(0.4)	—	(48.7)
Other income (expense), net	—	0.3	(0.1)	—	0.2
Total other expense, net	(48.4)	0.4	(0.5)	—	(48.5)
Income (loss) from continuing operations before income taxes	(53.5)	26.6	4.8	—	(22.1)
Provision for income taxes from continuing operations	0.5	1.9	0.5	—	2.9
Income (loss) from continuing operations	(54.0)	24.7	4.3	—	(25.0)
Income (loss) from discontinued operations	0.1	(4.9)	—	—	(4.8)
Equity in net income (loss) of subsidiaries	24.1	4.3	—	(28.4)	—
Net income (loss)	$ (29.8)	$ 24.1	$ 4.3	$ (28.4)	$ (29.8)
Comprehensive income (loss)	$ (29.8)	$ 24.1	$ 4.3	$ (28.4)	$ (29.8)

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Condensed Consolidating Statement of Operations and Comprehensive Income (Loss)
Nine Months Ended September 28, 2014
(Unaudited)
(in millions)

	Parent Company	Guarantors on a Combined Basis	Non-Guarantors on a Combined Basis	Eliminations	Consolidated
Service revenues	$ —	$ 292.3	$ 7.2	$ —	$ 299.5
Product sales	—	304.4	50.3	(7.7)	347.0
Total revenues	—	596.7	57.5	(7.7)	646.5
Cost of service revenues	—	224.1	5.6	—	229.7
Cost of product sales	—	228.4	34.1	(7.7)	254.8
Total costs	—	452.5	39.7	(7.7)	484.5
Gross profit	—	144.2	17.8	—	162.0
Selling, general and administrative expenses	11.9	113.8	10.1	—	135.8
Research and development expenses	—	15.8	1.2	—	17.0
Operating income from continuing operations	(11.9)	14.6	6.5	—	9.2
Other income (expense):					
Interest expense, net	(42.1)	0.1	(0.2)	—	(42.2)
Loss on extinguishment of debt	(39.1)	—	—	—	(39.1)
Other income (expense), net	—	0.1	(0.1)	—	—
Total other expense, net	(81.2)	0.2	(0.3)	—	(81.3)
Income (loss) from continuing operations before income taxes	(93.1)	14.8	6.2	—	(72.1)
Provision (benefit) for income taxes from continuing operations	0.9	1.8	1.0	—	3.7
Income (loss) from continuing operations	(94.0)	13.0	5.2	—	(75.8)
Income (loss) from discontinued operations	0.2	(0.2)	—	—	—
Equity in net income (loss) of subsidiaries	18.0	5.2	—	(23.2)	—
Net income (loss)	$ (75.8)	$ 18.0	$ 5.2	$ (23.2)	$ (75.8)
Comprehensive income (loss)	$ (76.0)	$ 18.0	$ 5.0	$ (23.0)	$ (76.0)

Condensed Consolidating Statement of Cash Flows
Nine Months Ended September 29, 2013
(Unaudited)
(in millions)

	Parent Company	Guarantors on a Combined Basis	Non-Guarantors on a Combined Basis	Eliminations	Consolidated
Net cash provided by (used in) operating activities	$ (33.4)	$ 40.7	$ 3.7	$ —	$ 11.0
Investing activities:					
Cash paid for acquisitions, net of cash acquired	—	2.2	—	—	2.2
Investment in affiliated companies	—	(32.4)	—	32.4	—
(Increase) decrease in restricted cash	—	0.5	—	—	0.5
Capital expenditures	(1.0)	(9.3)	(1.9)	—	(12.2)
Proceeds from sale of discontinued operations	—	0.4	—	—	0.4
Net cash provided by (used in) investing activities from continuing operations	(1.0)	(38.6)	(1.9)	32.4	(9.1)
Financing activities:					
Repayment of debt	—	—	(0.8)	—	(0.8)
Cash paid for contingent acquisition consideration	—	(2.1)	—	—	(2.1)
Financing from affiliated companies	29.6	—	2.8	(32.4)	—
Other, net	1.2	—	—	—	1.2
Net cash provided by (used in) financing activities from continuing operations	30.8	(2.1)	2.0	(32.4)	(1.7)
Net cash flows of continuing operations	(3.6)	—	3.8	—	0.2
Net operating cash flows from discontinued operations	—	0.5	—	—	0.5
Effect of exchange rate changes on cash and cash equivalents	—	—	0.1	—	0.1
Net increase (decrease) in cash and cash equivalents	$ (3.6)	$ 0.5	$ 3.9	$ —	$ 0.8

Condensed Consolidating Statement of Cash Flows
Nine Months Ended September 28, 2014
(Unaudited)
(in millions)

	Parent Company	Guarantors on a Combined Basis	Non-Guarantors on a Combined Basis	Eliminations	Consolidated
Net cash provided by (used in) operating activities	$ (33.4)	$ 21.1	$ (5.9)	$ —	$ (18.2)
Investing activities:					
Cash paid for acquisitions, net of cash acquired	—	(2.6)	—	—	(2.6)
Investment in affiliated companies	—	(12.2)	—	12.2	—
(Increase) decrease in restricted cash	—	(0.1)	—	—	(0.1)
Capital expenditures	(0.6)	(8.0)	(0.8)	—	(9.4)
Net cash used in investing activities from continuing operations	(0.6)	(22.9)	(0.8)	12.2	(12.1)
Financing activities:					
Proceeds from issuance of long-term debt	618.5	—	—	—	618.5
Extinguishment of long-term debt	(661.5)	—	—	—	(661.5)
Debt issuance costs	(8.5)	—	—	—	(8.5)
Credit agreement borrowings	41.0	—	—	—	41.0
Repayment of debt	—	—	(0.7)	—	(0.7)
Financings from affiliated companies	12.2	—	—	(12.2)	—
Other, net	3.3	—	—	—	3.3
Net cash provided by (used in) financing activities from continuing operations	5.0	—	(0.7)	(12.2)	(7.9)
Net cash flows of continuing operations	(29.0)	(1.8)	(7.4)	—	(38.2)
Net operating cash flows from discontinued operations	—	(1.2)	—	—	(1.2)
Effect of exchange rate changes on cash and cash equivalents	—	0.1	(0.2)	—	(0.1)
Net increase (decrease) in cash and cash equivalents	$ (29.0)	$ (2.9)	$ (7.6)	$ —	$ (39.5)

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

This Quarterly Report on Form 10-Q (this “Quarterly Report”) contains “forward-looking statements” relating to our future financial performance, the market for our services and our expansion plans and opportunities. In some cases, you can identify forward-looking statements by terminology such as “may,” “will,” “should,” “expect,” “plan,” “anticipate,” “believe,” “estimate,” “predict,” “potential,” or “continue,” the negative of such terms or other comparable terminology. These forward-looking statements reflect our current beliefs, expectations and projections, are based on assumptions, and are subject to known and unknown risks and uncertainties that could cause our actual results or achievements to differ materially from any future results or achievements expressed in or implied by our forward-looking statements. Many of these factors are beyond our ability to control or predict. As a result, you should not place undue reliance on forward-looking statements. The most important risks and uncertainties that could cause our actual results or achievements to differ materially from the results or achievements reflected in our forward-looking statements, include, but are not limited to: changes or cutbacks in spending or the appropriation of funding by the federal government, including the U.S. Department of Defense, which could cause delays, cancellations or reductions of key government contracts; changes in the scope or timing of our projects; the timing, rescheduling or cancellation of significant customer contracts and agreements, or consolidation by or the loss of key customers; risks of adverse regulatory action or litigation; risks associated with debt leverage; failure to successfully consummate acquisitions or integrate acquired operations; risks related to security breaches, cybersecurity attacks or other significant disruptions of our information systems; and competition in the marketplace, which could reduce revenues and profit margins, as well as the additional risks and uncertainties described in this Quarterly Report on Form 10-Q and in “Item 1A-Risk Factors” of our Annual Report on Form 10-K for the fiscal year ended December 29, 2013 filed with the Securities and Exchange Commission on March 12, 2014. These forward-looking statements reflect our views and assumptions only as of the date such forward-looking statements are made. Except as required by law, we assume no responsibility for updating any forward-looking statements, whether as a result of new information, future events or otherwise.

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

Overview

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

We design, engineer and manufacture specialized electronic components, subsystems and systems for electronic attack, electronic warfare, radar, and missile system platforms; integrated product, software and technology solutions for satellite communications; products and solutions for unmanned systems; products and services related to cybersecurity and cyberwarfare; products and solutions for ballistic missile defense; weapons systems trainers; advanced network engineering and information technology services; weapons systems lifecycle support and sustainment; military weapon range operations and technical services; and public safety, critical infrastructure security and surveillance systems. We believe our stable customer base, strong customer relationships, intellectual property, broad array of contract vehicles, "designed in" positions on strategic national security platforms, large employee base possessing specialized skills, specialized manufacturing facilities and equipment, extensive list of past performance qualifications, and significant management and operational capabilities position us for success.

We were incorporated in the state of New York on December 19, 1994 and began operations in March 1995. We reincorporated in the state of Delaware in 1998. We completed our exit of the commercial wireless industry, began building a national security focused business and changed the Company's name to Kratos Defense & Security Solutions, Inc. in September 2007.

Industry Update

On February 15, 2014, legislation was signed that raises the U.S. debt limit through March 2015. In addition, in January 2014, appropriators passed legislation that offsets a portion of the sequester cuts for fiscal 2014 and 2015. This translates to a somewhat better outlook for the defense industry than what was generally expected for both this year and next. However, we still expect lower or delayed awards on some of our programs, increased competition for a reduced defense outlay, and increased protest activity with a related negative impact on our revenues, earnings and cash flows.

In March 2014, the Pentagon submitted its FY 2015 Budget Request of approximately $496 billion, which is consistent with the Bipartisan Budget Spending Authorization. Also in March 2014, the Pentagon published the Quadrennial Defense Review ("QDR"). Both the Pentagon’s FY 2015 Budget Request and the QDR provide important insight for future national security funding priorities and related programs, which include cyber security and warfare, unmanned systems, satellite communications, missile defense and electronic warfare.

In September 2014, the President signed a FY2015 Continuing Resolution ("CR") that will fund the government through December 11, 2014. The bill sets the discretionary funding level for the federal government during CR period at an annual rate of $1.012 trillion. The House has passed seven of the twelve FY2015 appropriations bills while the Senate has passed none to date. As a result, Congress will have less than one month to reach agreement on the details of all 12 appropriations bills, put them together into an omnibus bill, and get the omnibus bill to the president by December 11th. If Congress does not meet this deadline it will need to pass another CR to avert a government shutdown.

Reportable Segments

We operate in two principal reportable business segments: Kratos Government Solutions (“KGS”) and Public Safety & Security (“PSS”). We organize our reportable business 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, and these intercompany transactions are eliminated in consolidation. The condensed consolidated financial statements in this Form 10-Q are presented in a manner consistent with our operating structure. For additional information regarding our reportable business segments, see Note 9 of the notes to the condensed consolidated financial statements. From a customer and solutions perspective, we view our business as an integrated whole, leveraging skills and assets wherever possible.

Strategic Acquisitions

We have historically supplemented our organic growth by identifying, acquiring and integrating businesses that meet our primary objective of providing us with the technology, intellectual property, manufacturing facilities and production equipment to address strategic national security programs and platforms, primarily in the unmanned systems, electronic warfare, satellite communications and missile system and radar areas of the DoD. We have also made certain acquisitions in the critical infrastructure security, strategic asset protection and public safety areas to expand our capabilities, scope, national depth, breadth and overall service offering.

Key Financial Statement Concepts

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

As of September 28, 2014, we consider the following factors to be important in understanding our financial statements.

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

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

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

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

Comparison of Results for the Three Months Ended September 29, 2013 to the Three Months Ended September 28, 2014

Revenues. Revenues by operating segment for the three months ended September 29, 2013 and September 28, 2014 are as follows (dollars in millions):

	September 29, 2013	September 28, 2014	$ change	% change
Kratos Government Solutions				
Service revenues	$ 57.0	$ 54.3	$ (2.7)	(4.7)%
Product sales	117.6	120.0	2.4	2.0 %
Total Kratos Government Solutions	174.6	174.3	(0.3)	(0.2)%
Public Safety & Security				
Service revenues	51.8	42.8	(9.0)	(17.4)%
Product sales	—	—	—	N/A
Total Public Safety & Security	51.8	42.8	(9.0)	(17.4)%
Total revenues	$ 226.4	$ 217.1	$ (9.3)	(4.1)%

Revenues decreased $9.3 million from $226.4 million for the three months ended September 29, 2013 to $217.1 million for the three months ended September 28, 2014. PSS segment revenue decreased by $9.0 million, primarily driven by the completion or wind-down of certain security installation projects which occurred in the third quarter of 2014, coupled with the delay in awards of new security installation projects, competitor protests, reprocurement of awards, delays in contract negotiation processes and general contract award delays. KGS segment revenue decreased by $0.3 million. This net decrease was primarily due to the continued contraction and commoditization of the Company’s legacy government services business of approximately $8.6 million, the expected reduction in two sizable satellite communications projects as the scope of work completed its natural contract life cycle transitioning from production to sustainment, resulting in net aggregate reduced revenues of $3.8 million, the reduction of shipments of certain of our aerial target products of $6.5 million, and delays in contract awards and competitor protests of new contracts awarded to the Company. These reductions were substantially offset by increased shipments in our specialized modular systems business of $6.5 million, increased work performed in our specialized air crew trainer business of $6.1 million, increased specialized work performed on government weapons ranges of $5.1 million, and increased shipments of our electronic warfare products of $1.5 million.

Product sales increased $2.4 million from $117.6 million for the three months ended September 29, 2013 to $120.0 million for the three months ended September 28, 2014, primarily as a result of increased production of our specialized modular systems and electronic warfare products, offset in part by the reduction of shipments of certain of our aerial target products. As a percentage of total revenue, product sales were 51.9% for the three months ended September 29, 2013 as compared to 55.3% for the three months ended September 28, 2014. Service revenues decreased by $11.7 million from $108.8 million for the three months ended September 29, 2013 to $97.1 million for the three months ended September 28, 2014. The decrease was primarily related to reductions in the legacy government service revenues and other service contracts in the KGS segment noted previously, which reductions are being experienced industry wide as a result of declining DoD budgets, changes in certain DoD procurement rules and other factors, and the reductions in our PSS business.

Cost of Revenues. Cost of revenues decreased $10.0 million from $174.1 million for the three months ended September 29, 2013 to $164.1 million for the three months ended September 28, 2014. The decrease in cost of revenues was primarily a result of the changes discussed above.

Gross margin increased from 23.1% for the three months ended September 29, 2013 to 24.4% for the three months ended September 28, 2014. Margins on services decreased from the three months ended September 29, 2013 to September 28, 2014, from 24.3% to 20.0%, respectively, due primarily to an unfavorable mix of revenues and decreased margins in our PSS segment. Margins on products increased from the three months ended September 29, 2013 to September 28, 2014 from 22.0% to 28.0%, respectively, primarily due to the mix of products shipped. Margins in the KGS segment increased from 22.6% for the three months ended September 29, 2013 to 26.6% for the three months ended September 28, 2014, primarily as a result of a favorable mix of revenues. In addition, margins on products in the three months ended September 29, 2013 were impacted by increased costs recorded of approximately $5.4 million on certain aerial target contracts to reflect retrofits necessary to address design changes. Similarly, margins in the three months ended September 28, 2014 were impacted by net increased costs recorded of $3.2 million for retrofit related matters and a contract conversion adjustment. Margins in the PSS segment declined from 24.7% for the three months ended September 29, 2013 to 15.7% for the three months ended September 28, 2014 due primarily to a less favorable mix of revenues, and due to costs incurred on two sizable projects which have been completed in the third quarter of 2014 or are near-completion, under which we are in the process of submitting or have submitted changes orders to these customers to reimburse us for the work we have performed at our customers request. We have not reflected the potential value of these customer change orders in our revenues, which has resulted in a reduction to our gross margins during the current quarter.

Selling, General and Administrative Expenses. Selling, general and administrative expenses (“SG&A”) decreased $2.0 million from $47.8 million for the three months ended September 29, 2013 to $45.8 million for the three months ended September 28, 2014, primarily as a result of a $3.3 million reduction of amortization of intangibles in 2014. As a percentage of revenues, SG&A remained flat at 21.1%. Excluding amortization of intangibles of $9.0 million for the three months ended September 29, 2013 and amortization of intangibles of $5.7 million for the three months ended September 28, 2014, SG&A increased as a percentage of revenues from 17.1% to 18.5%, or from $38.8 million to $40.1 million for the three months ended September 29, 2013 and September 28, 2014, respectively, due to an increase in non-cash stock compensation expense of $0.8 million, and due to increased infrastructure and business development investments made in our unmanned aerial drones and targets and combat aircraft business.

Merger and Acquisition Expenses. The expense of $0.2 million for the three months ended September 29, 2013 were related to legal costs associated with an acquired entity.

Internal Research and Development ("IR&D") Expenses. IR&D expenses were $4.8 million for the three months ended September 29, 2013 and $5.9 million for the three months ended September 28, 2014. As a percentage of revenues, IR&D increased from 2.1% of revenues in the three months ended September 29, 2013 to 2.7% of revenues in the three months ended September 28, 2014 as a result of certain investments the Company is making related to new programs and platforms in the electronic products business, the unmanned systems area, and the satellite communications business. We are making certain of these investments in conjunction with our customers, with the objectives of the Company’s products being “designed in” to these new long term program opportunities and the Company owning certain intellectual property rights for products that support these programs.

Unused office space and other restructuring. The benefit of $6.6 million for the three months ended September 29, 2013 was primarily due to a change in the estimated excess facility accrual of office space at our Colombia, Maryland administrative facilities partially offset by expenses related to workforce reductions as a result of cost reduction initiatives we have implemented across the Company. The expense of $0.1 million for the three months ended September 28, 2014 was primarily due to employee termination costs related to personnel reduction actions taken during the third quarter of 2014.

Other Expense, Net. Other expense, net decreased from $15.4 million to $12.5 million for the three months ended September 29, 2013 and September 28, 2014, respectively. The decrease in expense of $2.9 million is primarily related to a reduction in interest expense.

Provision for Income Taxes. Income tax expense (benefit) for the three months ended September 29, 2013 and September 28, 2014 was $0.2 million and $(0.2) million, respectively. These amounts were primarily a function of the estimated effective tax rate for the respective years. The estimated effective tax rate for any given year is driven by estimated foreign taxes, estimated state taxes, permanent book/tax differences, tax amortization of intangible assets that have an indefinite life under GAAP and the projected income or loss for the year.

Income (loss) from Discontinued Operations. Revenue from discontinued operations was $0.0 million and $0.0 million and (loss) income from discontinued operations was $(0.4) million and $0.2 million for the three months ended September 29, 2013 and September 28, 2014, respectively. The loss from discontinued operations for the three months ended September 29, 2013 and September 28, 2014 were primarily related to operations of the non-core businesses from the Integral acquisition that were classified as held for sale and subsequently sold. See Note 7 of the Notes to the Condensed Consolidated Financial Statements for a further discussion of our discontinued operations.

Comparison of Results for the Nine Months Ended September 29, 2013 to the Nine Months Ended September 28, 2014

Revenues. Revenues by operating segment for the nine months ended September 29, 2013 and September 28, 2014 are as follows (dollars in millions):

	September 29, 2013	September 28, 2014	$ change	% change
Kratos Government Solutions				
Service revenues	$ 180.9	$ 157.2	$ (23.7)	(13.1)%
Product sales	379.9	334.0	(45.9)	(12.1)%
Total Kratos Government Solutions	560.8	491.2	(69.6)	(12.4)%
Public Safety & Security				
Service revenues	154.1	142.3	(11.8)	(7.7)%
Product sales	—	13.0	13.0	N/A
Total Public Safety & Security	154.1	155.3	1.2	0.8 %
Total revenues	$ 714.9	$ 646.5	$ (68.4)	(9.6)%

Revenues decreased $68.4 million from $714.9 million for the nine months ended September 29, 2013 to $646.5 million for the nine months ended September 28, 2014. KGS segment revenue decreased by $69.6 million. The decrease in revenues were primarily due to competitor protests on awards made to Kratos, a decline in shipments of our defense products, delays in orders and awards as a result of the challenging federal government and DoD funding environment, all of which adversely impacted the timing of new contract awards, bookings and the Company's revenues. Additionally, revenue was also adversely impacted by the decrease resulting from the expected completion of two sizable satellite communications projects as the scope of work completed its natural contract life cycle transitioning from production to sustainment, which impacted revenues by approximately $13.3 million, continued ongoing weakness and increased competition and commoditization
in our legacy government services businesses of approximately $20.2 million, and the reduction of shipments of certain of our aerial target products of $32.1 million. PSS segment revenue increased by $1.2 million, primarily due to the delivery of security related communication equipment of $13 million, offset by the delay in contract awards and project starts in 2014.

Product sales decreased $32.9 million from $379.9 million for the nine months ended September 29, 2013 to $347.0 million for the nine months ended September 28, 2014, primarily as a result of the decline in product shipments due to the factors discussed above. As a percentage of total revenue, product sales were 53.1% for the nine months ended September 29, 2013 as compared to 53.7% for the nine months ended September 28, 2014. Service revenues decreased by $35.5 million from $335.0 million for the nine months ended September 29, 2013 to $299.5 million for the nine months ended September 28, 2014. The decrease was primarily related to reductions in the legacy government service revenues and other service contracts in the KGS segment, which reductions are being experienced industry wide as a result of declining DoD budgets, changes in certain DoD procurement rules and other factors, as well as due to the expected completion of two sizable satellite communications projects.

Cost of Revenues. Cost of revenues decreased $51.9 million from $536.4 million for the nine months ended September 29, 2013 to $484.5 million for the nine months ended September 28, 2014. The decrease in cost of revenues was primarily a result of the changes discussed above.

Gross margin increased from 25.0% for the nine months ended September 29, 2013 to 25.1% for the nine months ended September 28, 2014. Margins on services decreased from the nine months ended September 29, 2013 to September 28, 2014, from 24.1% to 23.3%, respectively, due primarily to a unfavorable mix of revenues and decreased margins in our PSS segment. Margins on products increased for the nine months ended September 29, 2013 to September 28, 2014 from 25.7% to 26.6%, respectively, primarily as a result of a mix of products shipped. Margins in the KGS segment increased from 24.8% for the nine months ended September 29, 2013 to 26.3% for the nine months ended September 28, 2014, primarily as a result of a favorable mix of revenues. In addition, margins on products in the nine months ended September 29, 2013 were impacted by increased costs recorded of approximately $5.4 million on certain aerial target contracts to reflect retrofits necessary to address design changes. Similarly, margins in the nine months ended September 28, 2014 were impacted by net increased costs recorded of $3.2 million for retrofit related matters and a contract conversion adjustment. Margins in the PSS segment decreased from 25.8% for the nine months ended September 29, 2013 and 21.0% for the nine months ended September 28, 2014, primarily due to decreased service margins and due to costs incurred on two sizable projects which have been completed in the third quarter of 2014 or are near-completion, under which we are in the process of submitting or have submitted changes orders to these customers to reimburse us for the work we have performed at our customers request. We have not reflected the potential value of these customer change orders in our revenues, which has resulted in a reduction to our gross margins during the current quarter.

Selling, General and Administrative Expenses. Selling, general and administrative expenses decreased $10.8 million from $144.9 million for the nine months ended September 29, 2013 to $134.1 million for the nine months ended September 28, 2014, primarily as a result a $10.3 million reduction of amortization of intangibles in 2014, as well as cost reduction actions taken by the Company. As a percentage of revenues, SG&A increased from 20.3% to 20.7%. Excluding amortization of intangibles of $27.3 million for the nine months ended September 29, 2013 and amortization of intangibles of $17.0 million for the nine months ended September 28, 2014, SG&A increased as a percentage of revenues from 16.4% to 18.1%, or from $117.6 million to $117.1 million for the nine months ended September 29, 2013 and September 28, 2014, respectively, primarily as a result of the decline in revenues discussed previously, offset in part by increased compliance costs including internal cyber security costs incurred to protect the Company's assets, Sarbanes Oxley and audit compliance costs including internal audit and external audit costs of $0.9 million.

Merger and Acquisition Expenses. The benefit of $2.3 million for the nine months ended September 29, 2013 was due to the reduction in a $3.1 million liability as a result of the final settlement of our indemnity obligations related to former directors and officers of Integral, partially offset by other merger expenses and legal fees related to prior acquisitions.

Internal Research and Development ("IR&D") Expenses. IR&D expenses were $14.5 million for the nine months ended September 29, 2013 and $17.0 million for the nine months ended September 28, 2014. As a percentage of revenues, IR&D increased from 2.0% of revenues in the nine months ended September 29, 2013 to 2.6% of revenues in the nine months ended September 28, 2014 as a result of certain investments the Company is making primarily related to new programs and platforms in the electronic products business, the unmanned systems area, and the satellite communications business. We are making certain of these investments in conjunction with our customers, with the objectives of the Company's products being "designed in" to these new long term program opportunities and the Company owning certain intellectual property rights for products that support these programs.

Unused office space and other restructuring. The credit of $5.0 million for the nine months ended September 29, 2013 was due to a reduction in the excess facility accrual of office space at the Columbia, Maryland administrative facilities, partially offset by expenses related to workforce reductions as a result of cost reduction initiatives we have implemented across the Company. The expense of $1.7 million for the nine months ended September 28, 2014 was primarily due to an estimated excess facility accrual of office space at our Sacramento, California administrative facilities, as well as due to employee termination costs related to personnel reduction actions taken during the nine-month period ended September 28, 2014.

Other Expense, Net. Other expense, net increased from $48.5 million to $81.3 million for the nine months ended September 29, 2013 and September 28, 2014, respectively. The increase in expense of $32.8 million is primarily related to $39.1 million loss on the extinguishment of the Company's 10% Senior Secured Notes due 2017.

Provision for Income Taxes. Income tax expense (benefit) for the nine months ended September 29, 2013 and September 28, 2014 was $2.9 million and $3.7 million, respectively. These amounts were primarily a function of the estimated effective tax rate for the respective years. The estimated effective tax rate for any given year is driven by estimated foreign taxes, estimated state taxes, permanent book/tax differences, tax amortization of intangible assets that have an indefinite life under GAAP and the projected income or loss for the year.

Income (loss) from Discontinued Operations. Revenue from discontinued operations was $3.6 million and $0 million and loss from discontinued operations was $4.8 million and $0.0 million for the nine months ended September 29, 2013 and September 28, 2014, respectively. The revenue and loss from discontinued operations for the nine months ended September 29, 2013 were primarily related to operations of the non-core businesses from the Integral acquisition that have been classified as held for sale. See Note 7 of the Notes to the Condensed Consolidated Financial Statements for a further discussion of our discontinued operations.

Backlog

At both September 29, 2013 and September 28, 2014, our backlog was approximately $1.0 billion of which $543.0 million was funded in 2013 and $533.0 million was funded in 2014. Backlog is our estimate of the amount of revenue we expect to realize over the remaining life of awarded contracts and task orders that we have in hand as of the measurement date. Our total backlog consists of funded and unfunded backlog. We define funded backlog as estimated future revenue under government contracts and task orders for which funding has been appropriated by Congress and authorized for expenditure by the applicable agency, plus our estimate of the future revenue we expect to realize from our commercial contracts that are under firm orders. Our funded backlog does not include the full potential value of our contracts because Congress often appropriates funds to be used by an agency for a particular program of a contract on a yearly or quarterly basis even though the contract may call for performance over a number of years. As a result, contracts typically are only partially funded at any point during their term, and all or some of the work to be performed under the contracts may remain unfunded unless and until Congress makes subsequent appropriation and the procuring agency allocates funding to the contract.

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

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

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

Liquidity and Capital Resources

As of September 28, 2014, we had cash and cash equivalents of $16.2 million compared with cash and cash equivalents of $55.7 million as of December 29, 2013, which includes $8.4 million and $16.0 million, respectively, of cash and cash equivalents held by our foreign subsidiaries. We are not presently aware of any restrictions on the repatriation of these funds; however, they are considered permanently invested in these foreign subsidiaries. If these funds were needed to fund our operations or satisfy obligations in the U.S. they could be repatriated, and their repatriation into the U.S. may cause us to incur additional U.S. income taxes or foreign withholding taxes. Any additional U.S. income taxes could be offset, in part or in whole, by foreign tax credits. The amount of such taxes and application of tax credits would be dependent on the income tax laws and other circumstances at the time these amounts are repatriated. Based on these variables, it is not practicable to determine the income tax liability that might be incurred if these earnings were to be repatriated. We do not currently intend to repatriate these earnings.

Our total debt, including capital lease obligations, principal due on Senior Secured Notes, and other term debt increased by $19.3 million from $644.7 million on December 29, 2013 to $664.0 million on September 28, 2014. The increase in debt was primarily due to an offering of $625.0 million aggregate principal amount of 7.00% Senior Secured Notes due 2019 in a private placement conducted pursuant to Rule 144A and Regulation S under the Securities Act of 1933, as amended. The proceeds from the offering, as well as borrowings of $41.0 million from our new credit facility and cash from operations were used to extinguish the Company’s existing 10% Senior Secured Notes due 2017 and to pay all fees and expenses related thereto.

Our operating cash flow is used to finance trade accounts receivable, inventory, capital expenditures, support ongoing operations, service our debt and make strategic acquisitions. Cash from continuing operations is primarily derived from our customer contracts in progress and associated changes in working capital components. Our Days Sales Outstanding (DSOs) have increased from 103 days at December 29, 2013 to 107 days as of September 28, 2014, primarily as a result of certain contractual milestones that have not yet been attained, such as equipment deliveries on a missile system program that has been delayed due to a subcontractor issue, and for certain flight requirements that must be fulfilled on certain aerial target programs, and therefore we are unable to bill for amounts outstanding related to those milestones. The challenging DoD budgetary environment described above, which has in certain instances caused delays in obtaining funding necessary to proceed with payments, has impacted our DSOs as well. Our accounts receivable balance of $255.1 million at September 28, 2014 includes $1.6 million of receivables due from a Greek customer under a subcontract arrangement Gichner Holdings, Inc. (“Gichner”) entered into with the Greek Ministry of Defense ("GMoD") in 2004 prior to our acquisition of Gichner in 2010. We do not have any significant direct exposure to European government receivables, and our customers do not rely heavily on European government subsidies or other European government support. We will continue to monitor our exposure to risks related to European sovereign debt.

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

	Nine Months Ended	
	September 29, 2013	September 28, 2014
Net cash provided by (used in) operating activities from continuing operations	$ 11.0	$ (18.2)
Net cash used in investing activities	(9.1)	(12.1)
Net cash used in financing activities from continuing operations	(1.7)	(7.9)
Net cash flows provided by (used in) discontinued operations	0.5	(1.2)

Net cash used in operating activities for the nine months ended September 28, 2014 was negatively impacted by reduced operating income and changes in working capital accounts. The use in working capital in the nine months ended September 28, 2014 is primarily related to production of certain combatant hardened facility product lines.

Net cash used in investing activities is primarily comprised of capital expenditures, which consist primarily of investment in machinery, computer hardware and software and improvement of our physical properties in order to maintain suitable conditions in which to conduct our business.

Net cash used in financing activities for the nine months ended September 28, 2014 reflects refinancing $625 million of our 10% Senior Secured Notes with $625 million of 7% Senior Secured Notes as well as a $41.0 million borrowing on our new Credit Agreement.

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

Contractual Obligations and Commitments

Issuance of 7% Senior Secured Notes due 2019

On May 14, 2014, the Company completed an offering of $625.0 million aggregate principal amount of 7.00% Senior Secured Notes due 2019 (the "Notes"). The proceeds from the offering, as well as borrowings of $41.0 million from our new credit facility and cash from operations, were used to refinance the Company's existing 10% Senior Secured Notes due 2017 (the "10% Notes") and to pay all fees and expenses related thereto. The loss on the extinguishment of the 10% Notes was $39.1 million.

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 28, 2014, the Company was in compliance with the covenants contained in the Indenture governing the Notes.

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, we may redeem up to 35% of the Notes at 107% before May 15, 2016 with the net proceeds of certain equity offerings. We 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, we 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 September 17, 2014, the Company commenced an offer to exchange the outstanding Notes for an equal amount of new 7.00% Senior Secured Notes due 2019 (the "Exchange Notes") that have been registered under the Securities Act of 1933, as amended. The Company made the exchange offer pursuant to the terms of the Registration Rights Agreement, dated May 14, 2014, that it entered into with the Guarantors and the representative of the initial purchasers of the Notes. The purpose of the exchange offer was to allow holders of the Notes to exchange their Notes for Exchange Notes that are not subject to transfer restrictions. The terms of the Exchange Notes are identical in all material respects to the terms of the Notes, except the Exchange Notes have been registered under the Securities Act. The Exchange Notes are fully and unconditionally guaranteed, jointly and severally, on a senior secured basis by the Company and each of its subsidiaries, as the guarantors thereof. The Company pays interest on the Exchange Notes semi-annually, in arrears, on May 15 and November 15 of each year. The Company completed the exchange offer on October 16, 2014, at which time the holders of all outstanding Notes had elected to exchange their Notes for Exchange Notes. The Company has no further obligations under the Registration Rights Agreement.

Other Indebtedness

$110.0 Million Credit Facility

On May 14, 2014, the Company replaced the credit facility with KeyBank National Association and entered into a Credit and Security Agreement (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 Lead Arranger and Sole Book Runner. The Credit Agreement establishes 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 the 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.

Borrowings under the 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. As of September 28, 2014, there was $41.0 million outstanding on the Credit Agreement and $12.4 million was outstanding on letters of credit, resulting in net borrowing base availability of $43.3 million. The Company was in compliance with the financial covenants as of September 28, 2014.

Debt Acquired in Acquisition

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 wholly owned subsidiaries. The balance as of September 28, 2014 was $4.0 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 28, 2014.

Other Liquidity Matters

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

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

Critical Accounting Principles and Estimates

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

For the nine months ended September 28, 2014, there have been no significant changes to our "Critical Accounting Policies or Estimates" as compared to the significant accounting policies described in the Form 10-K.

Item 3. Quantitative and Qualitative Disclosures About Market Risk.

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

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

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

Our cash and cash equivalents as of September 28, 2014 were $16.2 million and are primarily invested in money market interest bearing accounts. A hypothetical 10% adverse change in the average interest rate on our money market cash investments and short-term investments would have had no material effect on our net loss for the nine months ended September 28, 2014.

Item 4. Controls and Procedures.

Conclusions Regarding the Effectiveness of Disclosure Controls and Procedures

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

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

Based on the foregoing, our Principal Executive Officer and Principal Financial Officer concluded that our disclosure controls and procedures were effective at the reasonable assurance level as of September 28, 2014.

Changes in Internal Control Over Financial Reporting

There was no change in our internal control over financial reporting during the three months ended September 28, 2014 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings.

See Note 11 of the Notes to the Condensed Consolidated Financial Statements contained within this Quarterly Report on Form 10-Q for a discussion of our legal proceedings.

Item 1A. Risk Factors.

In evaluating us and our common stock, we urge you to carefully consider the risks and other information in this Quarterly Report on Form 10-Q, as well as the risk factors disclosed in Item 1A. to Part I of our Annual Report on Form 10-K for the fiscal year ended December 29, 2013, which we filed with the SEC on March 12, 2014. The risks and uncertainties described in “Item 1A - Risk Factors” of our Annual Report on Form 10-K have not materially changed. Any of the risks discussed in this Quarterly Report on Form 10-Q or any of the risks disclosed in Item 1A. to Part I of our Annual Report on Form 10-K for the fiscal year ended December 29, 2013.

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

There were no unregistered sales of the Company's equity securities during the nine month period ended September 28, 2014 that were not previously disclosed in a Current Report on Form 8-K.

Item 3. Defaults Upon Senior Securities.

None.

Item 4. Mine Safety Disclosures.

Not applicable.

Item 5. Other Information.

On November 4, 2014, the Board of Directors of Kratos Defense & Security Solutions, Inc. (the "Company") approved an amendment to the Company's Second Amended and Restated Bylaws to add a new Article 12 stipulating in what forum certain proceedings against the Company may be brought. Specifically, new Article 12 provides that, unless the Company consents in writing to the selection of an alternative forum, the Court of Chancery of the State of Delaware, or another state or the federal court located in the State of Delaware, will be the sole and exclusive forum for (1) any derivative action or proceeding brought on behalf of the Company, (2) any action asserting a claim of breach of a fiduciary duty owed by any director, officer or other employee of the Company to the Company or the Company's stockholders, (3) any action asserting a claim against the Company arising pursuant to any provision of the Delaware General Corporation Law or the Amended and Restated Certificate of Incorporation or Bylaws, or (4) any action involving the internal affairs doctrine. The amendment further provides that any person or entity purchasing or otherwise acquiring or holding any interest in shares of the Company's capital stock is deemed to have notice of and consented to the foregoing provision.

The foregoing summary of the amendment is qualified in its entirety by reference to the text of the Amendment to the Second Amended and Restated Bylaws as adopted by the Board of Directors, which is filed as Exhibit 3.8 to this Quarterly Report on Form 10-Q and is incorporated by reference herein.

Item 6. Exhibits.

Exhibit Number	Exhibit Description	Incorporated by Reference Form	Filing Date/ Period End Date	Exhibit	Filed-Furnished Herewith
2.1#	Stock Purchase Agreement, dated May 8, 2012, by and among Kratos Defense & Security Solutions, Inc., Composite Engineering, Inc., and Amy Fournier, the stockholders representative	8-K	05/08/2012	2.1	
2.2#	Agreement and Plan of Merger, dated May 15, 2011, by and among Kratos Defense & Security Solutions, Inc., Integral Systems, Inc., IRIS Merger Sub Inc., and IRIS Acquisition Sub LLC.	8-K	05/18/2011	2.1	
2.3#	Agreement and Plan of Merger, dated February 7, 2011, by and among Kratos Defense & Security Solutions, Inc., Lanza Acquisition, Co. and Herley Industries, Inc. (incorporated by reference to Annex A to the Prospectus Supplement dated February 8, 2011, pursuant to the Registration Statement on Form S-3 of Kratos Defense & Security Solutions, Inc.)	424	02/08/2011	n/a	
3.1	Amended and Restated Certificate of Incorporation of Kratos Defense & Security Solutions, Inc.	10-Q	9/30/2001(000-27231)	4.1	
3.2	Certificate of Ownership and Merger of Kratos Defense & Security Solutions, Inc. into Wireless Facilities, Inc.	8-K	9/14/2007(000-27231)	3.1	
3.3	Certificate of Amendment to Amended and Restated Certificate of Incorporation of Kratos Defense & Security Solutions, Inc.	10-Q	09/27/2009	3.1	
3.4	Certificate of Designations, Preferences and Rights of Series A Preferred Stock.	10-Q	9/30/2001(000-27231)	4.2	
3.5	Certificate of Designations, Preferences and Rights of Series B Preferred Stock (included as Exhibit A to the Preferred Stock Purchase Agreement dated as of May 16, 2002 among the Company, Meritech Capital Partners II L.P., Meritech Capital Affiliates II L.P., MCB Entrepreneur Partners II L.P., Oak Investment Partners X, Limited Partnership, Oak X Affiliates Fund, Limited Partnership, Oak Investment Partners IX, L.P, Oak Affiliates Fund, L.P, Oak IX Affiliates Fund-A, L.P, and the KLS Trust dated July 14, 1999).	8-K/A	6/5/2002(000-27231)	4.1	
3.6	Certificate of Designation of Series C Preferred Stock.	8-K	12/17/2004(000-27231)	3.1	
3.7	Second Amended and Restated Bylaws of Kratos Defense & Security Solutions, Inc.	8-K	03/15/2011	3.1	
3.8	Amendment to Second Amended and Restated Bylaws of Kratos Defense & Security Solutions, Inc.				*
4.1	Specimen Stock Certificate.	10-K	12/26/2010	4.1	
4.2	Rights Agreement, dated as of December 16, 2004, between Kratos Defense & Security Solutions, Inc. and Wells Fargo, N.A.	8-K	12/17/2004(000-27231)	4.1	

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Exhibit Number	Exhibit Description	Incorporated by Reference: Form	Filing Date/ Period End Date	Exhibit	Filed-Furnished Herewith
4.3	Amendment No. 1 to Rights Agreement, dated as of May 14, 2012, between Kratos Defense & Security Solutions, Inc. and Wells Fargo, N.A.	8-K	05/15/2012	4.1	
4.4	Form of 10% Senior Secured Note due 2017 (issuable in connection with the October 2011 exchange offer).	S-4	10/25/2011	4.2	
4.5	Indenture, dated March 25, 2011, by and among Acquisition Co. Lanza Parent, the Guarantors named therein and a party thereto, and Wilmington Trust FSB, as Trustee and Collateral Agent (including the Form of 10% Senior Secured Notes).	8-K	03/29/2011	4.1	
4.6	First Supplemental Indenture, date April 4, 2011, by and among Kratos Defense & Security Solutions, Inc., Herley Industries, Inc. and Wilmington Trust FSB, as Trustee and Collateral Agent, to the Indenture, dated as of March 25, 2011, among Kratos Defense & Security Solutions, Inc., the Guarantor party thereto and Wilmington Trust FSB, as Trustee and Collateral Agent.	8-K	04/04/2011	4.2	
4.7	Registration Rights Agreement, dated March 25, 2011, by and among Kratos Defense & Security Solutions, Inc., Acquisition Co. Lanza Parent, Lanza Acquisition Co., the Guarantors named therein, Jefferies & Company, Inc., KeyBanc Capital Markets Inc. and Oppenheimer & Co. Inc.	8-K	03/29/2011	4.2	
4.8	Registration Rights Agreement, dated July 27, 2011, by and among Kratos Defense & Security Solutions, Inc., the guarantors named therein, Jefferies & Company, Inc., KeyBanc Capital Markets Inc. and B. Riley & Co., LLC.	8-K	07/29/2011	4.2	
4.9	Indenture, dated May 14, 2014, among Kratos Defense & Security Solutions, Inc., as Issuer, the Guarantors party thereto, and Wilmington Trust, National Association, as Trustee and Collateral Agent.	8-K	05/15/2014	4.1	
4.10	Registration Rights Agreement dated May 14, 2014 among Kratos Defense & Security Solutions, Inc., as Issuer, the Guarantors party thereto, and SunTrust Robinson Humphrey, Inc., as Representative of the Initial Purchasers.	8-K	05/15/2014	10.1	
10.1+	Form of Restricted Stock Unit Grant & Award Agreement				*
31.1	Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes Oxley Act of 2002.				*
31.2	Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes Oxley Act of 2002.				*
32.1	Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 for Eric M. DeMarco.				*

Exhibit Number	Exhibit Description	Incorporated by Reference			Filed-Furnished Herewith
		Form	Filing Date/ Period End Date	Exhibit	
32.2	Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 for Deanna Lund.				*
101	Financial statements from the Quarterly Report on Form 10-Q of Kratos Defense & Security Solutions, Inc. for the quarter ended September 28, 2014 formatted in XBRL: (i) the Condensed Consolidated Balance Sheets, (ii) the Condensed Consolidated Statements of Operations and Comprehensive Income, (iii) the Condensed Consolidated Statements of Cash Flows, (iv) the Notes to the Condensed Consolidated Financial Statements.				*

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

+ Management contract or compensatory plan or arrangement.

SIGNATURES

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

KRATOS DEFENSE & SECURITY SOLUTIONS, INC.

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

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

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

By: /s/ RICHARD DUCKWORTH
Richard Duckworth
Vice President and Corporate Controller
(Principal Accounting Officer)

Date: November 7, 2014

Exhibit 3.8

AMENDMENT TO THE
SECOND AMENDED AND RESTATED BYLAWS
OF
KRATOS DEFENSE & SECURITY SOLUTIONS, INC.

November 4, 2014

The undersigned hereby certifies that:

1. She is the duly appointed and acting Secretary of Kratos Defense & Security Solutions, Inc., a Delaware corporation (the "**Corporation**").

2. The current Second Amended and Restated Bylaws of the Corporation were adopted on March 10, 2011 ("**Restated Bylaws**").

3. The Restated Bylaws shall be amended to add the following Article 12 Forum for Certain Actions:

"ARTICLE 12
FORUM FOR CERTAIN ACTIONS

Unless the corporation consents in writing to the selection of an alternative forum, the sole and exclusive forum for (i) any derivative action or proceeding brought on behalf of the corporation, (ii) any action asserting a claim of breach of a fiduciary duty owed by any director, officer or other employee of the corporation to the corporation or the corporation's stockholders, (iii) any action asserting a claim against the corporation arising pursuant to any provision of the Delaware General Corporation Law or the Amended and Restated Certificate of Incorporation or Bylaws, or (iv) any action involving the internal affairs doctrine shall be the Court of Chancery of the State of Delaware or, if the Court of Chancery determines it does not have jurisdiction, in another state or the federal court located within the State of Delaware, in all cases subject to the court's having personal jurisdiction over the indispensable parties named as defendants. Any person or entity purchasing or otherwise acquiring any interest in shares of capital stock of the corporation shall be deemed to have notice of and consented to the provisions of this Article XII."

4. The foregoing Amendment was duly approved by the Corporation's Board of Directors in accordance with Section 109 of the Delaware General Corporation Law and pursuant to Article 11 of the Restated Bylaws. This amendment may only be altered or amended in accordance with the provisions set forth in the Restated Bylaws.

5. Except as otherwise expressly provided herein, the Restated Bylaws will continue in full force and effect, in accordance with their terms.

[*Remainder of Page Intentionally Left Blank*]

IN WITNESS WHEREOF, the undersigned has executed this Amendment to the Second Amended and Restated Bylaws on behalf of the Corporation as of the date first set forth above.

KRATOS DEFENSE & SECURITY SOLUTIONS, INC.,
a Delaware corporation

/s/ Deborah Butera

Deborah Butera, Secretary

EXHIBIT 10.1

KRATOS DEFENSE & SECURITY SOLUTIONS, INC.
RESTRICTED STOCK UNIT GRANT NOTICE
(2014 EQUITY INCENTIVE PLAN)
(STANDARD FORM)

Kratos Defense & Security Solutions, Inc. (the "***Company***"), pursuant to Section 6(b) of the Company's 2014 Equity Incentive Plan (the "***Plan***"), hereby awards to Participant a Restricted Stock Unit Award for the number of shares of the Company's Common Stock ("***Restricted Stock Units***") set forth below (the "***Award***"). The Award is subject to all of the terms and conditions as set forth in this notice of grant (this "***Restricted Stock Unit Grant Notice***") and in the Plan and the Restricted Stock Unit Award Agreement (the "***Award Agreement***"), both of which are attached hereto and incorporated herein in their entirety. Capitalized terms not otherwise defined herein shall have the meanings set forth in the Plan or the Award Agreement. In the event of any conflict between the terms in the Award and the Plan, the terms of the Plan shall control.

Participant:
Date of Grant:
Number of Restricted Stock Units/Shares:

Vesting Schedule: Your Award will vest one hundred percent (100%) on the ___________________ (the "***Vesting Date***") of the Grant Date, provided that you continue to provide service as an Employee to the Company on the Vesting Date.

Issuance Schedule: Subject to any change on a Capitalization Adjustment, one share of Common Stock will be issued for each Restricted Stock Unit that vests at the time set forth in Section 6 of the Award Agreement.

Additional Terms/Acknowledgements: Participant acknowledges receipt of, and understands and agrees to, this Restricted Stock Unit Grant Notice, the Award Agreement and the Plan. Participant further acknowledges that as of the Date of Grant, this Restricted Stock Unit Grant Notice, the Award Agreement and the Plan set forth the entire understanding between Participant and the Company regarding the acquisition of the Common Stock pursuant to the Award specified above and supersede all prior oral and written agreements on the terms of this Award with the exception, if applicable, of (i) the written employment agreement or offer letter agreement entered into between the Company and Participant specifying the terms that should govern this specific Award, and (ii) any compensation recovery policy that is adopted by the Company or is otherwise required by applicable law.

By accepting this Award, Participant acknowledges having received and read the Restricted Stock Unit Grant Notice, the Award Agreement and the Plan and agrees to all of the terms and conditions set forth in these documents. Participant consents to receive Plan documents by electronic delivery and to participate in the Plan through an on-line or electronic system established and maintained by the Company or another third party designated by the Company.

KRATOS DEFENSE & SECURITY SOLUTIONS, INC.		**PARTICIPANT:**	
By:	______________________	By:	______________________
Name:	______________________		
Title:	______________________		

ATTACHMENTS: Award Agreement and 2014 Equity Incentive Plan

KRATOS DEFENSE & SECURITY SOLUTIONS, INC.
2014 EQUITY INCENTIVE PLAN
RESTRICTED STOCK UNIT AWARD AGREEMENT
(STANDARD FORM)

Pursuant to the Restricted Stock Unit Grant Notice (the "***Grant Notice***") and this Restricted Stock Unit Award Agreement (the "***Award Agreement***"), Kratos Defense & Security Solutions, Inc. (the "***Company***") has awarded you ("***Participant***") a Restricted Stock Unit Award (the "***Award***") pursuant to Section 6(b) of the Company's 2014 Equity Incentive Plan (the "***Plan***") for the number of Restricted Stock Units/shares indicated in the Grant Notice. Capitalized terms not explicitly defined in this Award Agreement or the Grant Notice shall have the same meanings given to them in the Plan. The terms of your Award, in addition to those set forth in the Grant Notice, are as follows.

1. GRANT OF THE AWARD. This Award represents the right to be issued on a future date one (1) share of Common Stock for each Restricted Stock Unit that vests on the applicable vesting date(s) (subject to any adjustment under Section 3 below) as indicated in the Grant Notice. As of the Date of Grant, the Company will credit to a bookkeeping account maintained by the Company for your benefit (the "***Account***") the number of Restricted Stock Units/shares of Common Stock subject to the Award. This Award was granted in consideration of your services to the Company.

2. VESTING. Subject to the limitations contained herein, your Award will vest, if at all, in accordance with the vesting schedule provided in the Grant Notice, provided that vesting will cease upon the termination of your Continuous Service. Upon such termination of your Continuous Service, the Restricted Stock Units/shares of Common Stock credited to the Account that were not vested on the date of such termination will be forfeited at no cost to the Company and you will have no further right, title or interest in or to such underlying shares of Common Stock.

3. NUMBER OF SHARES. The number of Restricted Stock Units/shares subject to your Award may be adjusted from time to time for Capitalization Adjustments, as provided in the Plan. Any additional Restricted Stock Units, shares, cash or other property that becomes subject to the Award pursuant to this Section 3, if any, shall be subject, in a manner determined by the Board, to the same forfeiture restrictions, restrictions on transferability, and time and manner of delivery as applicable to the other Restricted Stock Units and shares covered by your Award. Notwithstanding the provisions of this Section 3, no fractional shares or rights for fractional shares of Common Stock shall be created pursuant to this Section 3. Any fraction of a share will be rounded down to the nearest whole share.

4. SECURITIES LAW COMPLIANCE. You may not be issued any Common Stock under your Award unless the shares of Common Stock underlying the Restricted Stock Units are either (i) then registered under the Securities Act, or (ii) the Company has determined that such issuance would be exempt from the registration requirements of the Securities Act. Your Award must also comply with other applicable laws and regulations governing the Award, and you shall not receive such Common Stock if the Company determines that such receipt would not be in material compliance with such laws and regulations.

5. TRANSFER RESTRICTIONS. Prior to the time that shares of Common Stock have been delivered to you, you may not transfer, pledge, sell or otherwise dispose of this Award or the shares issuable in respect of your Award, except as expressly provided in this Section 5. For example, you may not use shares that may be issued in respect of your Restricted Stock Units as security for a loan. The restrictions on transfer set forth herein will lapse upon delivery to you of shares in respect of your vested Restricted Stock Units.

(a) Death. Your Award is transferable by will and by the laws of descent and distribution. At your death, vesting of your Award will cease and your executor or administrator of your estate shall be entitled to receive, on behalf of your estate, any Common Stock or other consideration that vested but was not issued before your death.

(b) Domestic Relations Orders. Upon receiving written permission from the Board or its duly authorized designee, and provided that you and the designated transferee enter into transfer and other agreements required by the Company, you may transfer your right to receive the distribution of Common Stock or other consideration hereunder, pursuant to a domestic relations order or marital settlement agreement that contains the information required by the Company to effectuate the transfer. You are encouraged to discuss the proposed terms of any division of this Award with the Company General Counsel prior to finalizing the domestic relations order or marital settlement agreement to verify that you may make such transfer, and if so, to help ensure the required information is contained within the domestic relations order or marital settlement agreement.

6. DATE OF ISSUANCE.

(a) The issuance of shares in respect of the Restricted Stock Units is intended to comply with Treasury Regulations Section 1.409A-1(b)(4) and will be construed and administered in such a manner. Subject to the satisfaction of the withholding obligations set forth in this Award Agreement, in the event one or more Restricted Stock Units vests, the Company shall issue to you one (1) share of Common Stock for each Restricted Stock Unit that vests on the applicable vesting date(s) (subject to any adjustment under Section 3 above). The issuance date determined by this paragraph is referred to as the "***Original Issuance Date***".

(b) The Original Issuance Date will be on a business day as soon as practicable after the applicable vesting date. In addition, if:

(i) the Original Issuance Date does not occur (1) during an "open window period" applicable to you, as determined by the Company in accordance with the Company's then-effective policy on trading in Company securities, or (2) on a date when you are otherwise permitted to sell shares of Common Stock on an established stock exchange or stock market, *and*

(ii) either (1) Withholding Taxes do not apply, or (2) the Company decides, prior to the Original Issuance Date, (A) not to satisfy the Withholding Taxes by withholding shares of Common Stock from the shares otherwise due, on the Original Issuance Date, to you under this Award, and (B) not to permit you to pay your Withholding Taxes in cash, then the shares that would otherwise be issued to you on the Original Issuance Date will not be delivered on such Original Issuance Date and will instead be delivered on the first business day when you are not prohibited from selling shares of the Company's Common Stock in the open public market, but in no event later than December 31 of the calendar year in which the Original Issuance Date occurs (that is, the last day of your taxable year in which the Original Issuance Date occurs), or, if and only if permitted in a manner that complies with Treasury Regulations Section 1.409A-1(b)(4), no later than the date that is the 15th day of the third calendar month of the applicable year following the year in which the shares of Common Stock under this Award are no longer subject to a "substantial risk of forfeiture" within the meaning of Treasury Regulations Section 1.409A-1(d).

(c) The form of delivery (*e.g.*, a stock certificate or electronic entry evidencing such shares) shall be determined by the Company.

7. DIVIDENDS. You shall receive no benefit or adjustment to your Award with respect to any cash dividend, stock dividend or other distribution that does not result from a Capitalization Adjustment.

8. RESTRICTIVE LEGENDS. The shares of Common Stock issued under your Award shall be endorsed with appropriate legends as determined by the Company.

9. EXECUTION OF DOCUMENTS. You hereby acknowledge and agree that the manner selected by the Company by which you indicate your consent to your Grant Notice is also deemed to be your execution of your Grant Notice and of this Award Agreement. You further agree that such manner of indicating consent may be relied upon as your signature for establishing your execution of any documents to be executed in the future in connection with your Award.

10. INTENTIONALLY OMITTED.

11. AWARD NOT A SERVICE CONTRACT.

(a) Nothing in this Award Agreement (including, but not limited to, the vesting of your Award or the issuance of the shares subject to your Award), the Plan or any covenant of good faith and fair dealing that may be found implicit in this Award Agreement or the Plan shall: (i) confer upon you any right to continue in the employ of, or affiliation with, the Company or an Affiliate; (ii) constitute any promise or commitment by the Company or an Affiliate regarding the fact or nature of future positions, future work assignments, future compensation or any other term or condition of employment or affiliation; (iii) confer any right or benefit under this Award Agreement or the Plan unless such right or benefit has specifically accrued under the terms of this Award Agreement or Plan; or (iv) deprive the Company of the right to terminate you at will and without regard to any future vesting opportunity that you may have.

(b) The Company has the right to reorganize, sell, spin-out or otherwise restructure one or more of its businesses or Affiliates at any time or from time to time, as it deems appropriate (a "***reorganization***"). Such a reorganization could result in the termination of your Continuous Service, or the termination of Affiliate status of your employer and the loss of benefits available to you under this Award Agreement, including but not limited to, the termination of the right to continue vesting in the Award. This Award Agreement, the Plan, the transactions contemplated hereunder and the vesting schedule set forth herein or any covenant of good faith and fair dealing that may be found implicit in any of them do not constitute an express or implied promise of continued engagement as an employee or consultant for the term of this Award Agreement, for any period, or at all, and shall not interfere in any way with the Company's right to conduct a reorganization.

12. WITHHOLDING OBLIGATIONS.

(a) On each vesting date, and on or before the time you receive a distribution of the shares underlying your Restricted Stock Units, and at any other time as reasonably requested by the Company in accordance with applicable tax laws, you hereby authorize any required withholding from the Common Stock issuable to you and/or otherwise agree to make adequate provision in cash for any sums required to satisfy the federal, state, local and foreign tax withholding obligations of the Company or any Affiliate that arise in connection with your Award (the "***Withholding Taxes***"). Additionally, the Company or any Affiliate may, in its sole discretion, satisfy all or any portion of the Withholding Taxes obligation relating to your Award by any of the following means or by a combination of such means: (i) withholding from any compensation otherwise payable to you by the Company; (ii) causing you to tender a cash payment; (iii) permitting or requiring you to enter into a "same day sale" commitment, if applicable, with a broker-dealer that is a member of the Financial Industry Regulatory Authority (a "***FINRA Dealer***") whereby you irrevocably elect to sell a portion of the shares to be delivered in connection with your Restricted Stock Units to satisfy the Withholding Taxes and whereby the FINRA Dealer irrevocably commits to forward the proceeds necessary to satisfy the Withholding Taxes directly to the Company and/or its Affiliates; or (iv) withholding shares of Common Stock from the shares of Common Stock issued or otherwise issuable to you in connection with the Award with a Fair Market Value (measured as of the date shares of Common Stock are issued to pursuant to Section 6) equal to the amount of such Withholding Taxes; *provided*, *however*, that the number of such shares of Common Stock so withheld will not exceed the amount necessary to satisfy the Company's required tax withholding obligations using the minimum statutory withholding rates for federal, state, local and foreign tax purposes, including payroll taxes, that are applicable to supplemental taxable income; and *provided*, further, that to the extent necessary to qualify for an exemption from application of Section 16(b) of the Exchange Act, if applicable, such share withholding procedure will be subject to the express prior approval of the Company's Compensation Committee.

(b) Unless the tax withholding obligations of the Company and/or any Affiliate are satisfied, the Company shall have no obligation to deliver to you any Common Stock.

(c) In the event the Company's obligation to withhold arises prior to the delivery to you of Common Stock or it is determined after the delivery of Common Stock to you that the amount of the Company's withholding obligation was greater than the amount withheld by the Company, you agree to indemnify and hold the Company harmless from any failure by the Company to withhold the proper amount.

13. TAX CONSEQUENCES. The Company has no duty or obligation to minimize the tax consequences to you of this Award and shall not be liable to you for any adverse tax consequences to you arising in connection with this Award. You are hereby advised to consult with your own personal tax, financial and/or legal advisors regarding the tax consequences of this Award and by signing the Grant Notice, you have agreed that you have done so or knowingly and voluntarily declined to do so. You understand that you (and not the Company) shall be responsible for your own tax liability that may arise as a result of this investment or the transactions contemplated by this Award Agreement.

14. UNSECURED OBLIGATION. Your Award is unfunded, and as a holder of a vested Award, you shall be considered an unsecured creditor of the Company with respect to the Company's obligation, if any, to issue shares or other property pursuant to this Award Agreement. You shall not have voting or any other rights as a stockholder of the Company with respect to the shares to be issued pursuant to this Award Agreement until such shares are issued to you pursuant to Section 6 of this Award Agreement. Upon such issuance, you will obtain full voting and other rights as a stockholder of the Company. Nothing contained in this Award Agreement, and no action taken pursuant to its provisions, shall create or be construed to create a trust of any kind or a fiduciary relationship between you and the Company or any other person.

15. NOTICES. Any notice or request required or permitted hereunder shall be given in writing to each of the other parties hereto and shall be deemed effectively given on the earlier of (i) the date of personal delivery, including delivery by express courier, or delivery via electronic means, or (ii) the date that is five (5) days after deposit in the United States Post Office (whether or not actually received by the addressee), by registered or certified mail with postage and fees prepaid, addressed at the following addresses, or at such other address(es) as a party may designate by ten (10) days' advance written notice to each of the other parties hereto:

COMPANY: Kratos Defense & Security Solutions, Inc.
Attn: Stock Administrator
4820 Eastgate Mall, Suite 200
San Diego, CA 92121

PARTICIPANT: Your address as on file with the Company
at the time notice is given

16. HEADINGS. The headings of the Sections in this Award Agreement are inserted for convenience only and shall not be deemed to constitute a part of this Award Agreement or to affect the meaning of this Award Agreement.

17. MISCELLANEOUS.

(a) The rights and obligations of the Company under your Award shall be transferable by the Company to any one or more persons or entities, and all covenants and agreements hereunder shall inure to the benefit of, and be enforceable by, the Company's successors and assigns.

(b) You agree upon request to execute any further documents or instruments necessary or desirable in the sole determination of the Company to carry out the purposes or intent of your Award.

(c) You acknowledge and agree that you have reviewed your Award in its entirety, have had an opportunity to obtain the advice of counsel prior to executing and accepting your Award and fully understand all provisions of your Award.

(d) This Award Agreement shall be subject to all applicable laws, rules, and regulations, and to such approvals by any governmental agencies or national securities exchanges as may be required.

(e) All obligations of the Company under the Plan and this Award Agreement shall be binding on any successor to the Company, whether the existence of such successor is the result of a direct or indirect purchase, merger, consolidation, or otherwise, of all or substantially all of the business and/or assets of the Company.

18. GOVERNING PLAN DOCUMENT. Your Award is subject to all the provisions of the Plan, the provisions of which are hereby made a part of your Award, and is further subject to all interpretations, amendments, rules and regulations which may from time to time be promulgated and adopted pursuant to the Plan. Your Award (and any compensation paid or shares issued under your Award) is subject to recoupment in accordance with The Dodd–Frank Wall Street Reform and Consumer Protection Act and any implementing regulations thereunder, any clawback policy adopted by the Company and any compensation recovery policy otherwise required by applicable law. No recovery of compensation under such a clawback policy will be an event giving rise to a right to voluntarily terminate employment upon a resignation for “good reason,” or for a “constructive termination” or any similar term under any plan of or agreement with the Company.

19. EFFECT ON OTHER EMPLOYEE BENEFIT PLANS. The value of the Award subject to this Award Agreement shall not be included as compensation, earnings, salaries, or other similar terms used when calculating benefits under any employee benefit plan (other than the Plan) sponsored by the Company or any Affiliate except as such plan otherwise expressly provides. The Company expressly reserves its rights to amend, modify, or terminate any or all of the employee benefit plans of the Company or any Affiliate.

20. CHOICE OF LAW. The interpretation, performance and enforcement of this Award Agreement shall be governed by the law of the State of California without regard to that state’s conflicts of laws rules.

21. SEVERABILITY. If all or any part of this Award Agreement or the Plan is declared by any court or governmental authority to be unlawful or invalid, such unlawfulness or invalidity shall not invalidate any portion of this Award Agreement or the Plan not declared to be unlawful or invalid. Any Section of this Award Agreement (or part of such a Section) so declared to be unlawful or invalid shall, if possible, be construed in a manner which will give effect to the terms of such Section or part of a Section to the fullest extent possible while remaining lawful and valid.

22. OTHER DOCUMENTS. You hereby acknowledge receipt or the right to receive a document providing the information required by Rule 428(b)(1) promulgated under the Securities Act. In addition, you acknowledge receipt of the Company's Avoidance of *Insider Trading and Procedures for Section 16 Compliance Policy*.

23. AMENDMENT. This Award Agreement may not be modified, amended or terminated except by an instrument in writing, signed by you and by a duly authorized representative of the Company. Notwithstanding the foregoing, this Award Agreement may be amended solely by the Board by a writing which specifically states that it is amending this Award Agreement, so long as a copy of such amendment is delivered to you, and provided that, except as otherwise expressly provided in the Plan, no such amendment materially adversely affecting your rights hereunder may be made without your written consent. Without limiting the foregoing, the Board reserves the right to change, by written notice to you, the provisions of this Award Agreement in any way it may deem necessary or advisable to carry out the purpose of the Award as a result of any change in applicable laws or regulations or any future law, regulation, ruling, or judicial decision, provided that any such change shall be applicable only to rights relating to that portion of the Award which is then subject to restrictions as provided herein.

24. COMPLIANCE WITH SECTION 409A OF THE CODE. This Award is intended to comply with the "short-term deferral" rule set forth in Treasury Regulation Section 1.409A-1(b)(4). Notwithstanding the foregoing, if it is determined that the Award fails to satisfy the requirements of the short-term deferral rule and is otherwise deferred compensation subject to Section 409A, and if you are a "Specified Employee" (within the meaning set forth in Section 409A(a)(2)(B)(i) of the Code) as of the date of your "separation from service" (within the meaning of Treasury Regulation Section 1.409A-1(h) and without regard to any alternative definition thereunder), then the issuance of any shares that would otherwise be made upon the date of the separation from service or within the first six (6) months thereafter will not be made on the originally scheduled date(s) and will instead be issued in a lump sum on the date that is six (6) months and one day after the date of the separation from service, with the balance of the shares issued thereafter in accordance with the original vesting and issuance schedule set forth above, but if and only if such delay in the issuance of the shares is necessary to avoid the imposition of adverse taxation on you in respect of the shares under Section 409A of the Code. Each installment of shares that vests is intended to constitute a "separate payment" for purposes of Treasury Regulation Section 1.409A-2(b)(2).

* * * * *

This Restricted Stock Unit Award Agreement shall be deemed to be signed by the Company and the Participant upon the signing by the Participant of the Restricted Stock Unit Grant Notice to which it is attached.

EXHIBIT 31.1

CERTIFICATION OF PRINCIPAL EXECUTIVE OFFICER
PURSUANT TO SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002

I, Eric M. DeMarco, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Kratos Defense & Security Solutions, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

   (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

   (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

   (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

   (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

   (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

   (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 7, 2014

KRATOS DEFENSE & SECURITY SOLUTIONS, INC.

/s/ ERIC M. DEMARCO

Eric M. DeMarco
Chief Executive Officer, President
(Principal Executive Officer)

EXHIBIT 31.2

CERTIFICATION OF PRINCIPAL EXECUTIVE OFFICER
PURSUANT TO SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002

I, Deanna H. Lund, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Kratos Defense & Security Solutions, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

   (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

   (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

   (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

   (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

   (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

   (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 7, 2014

KRATOS DEFENSE & SECURITY SOLUTIONS, INC.

/s/ DEANNA H. LUND

Deanna H. Lund
Executive Vice President, Chief Financial Officer
(Principal Financial Officer and Acting Principal Accounting Officer)

EXHIBIT 32.1

CERTIFICATION PURSUANT TO SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002
(18 U.S.C. SECTION 1350)

In connection with the accompanying Quarterly Report of Kratos Defense & Security Solutions, Inc. (the "Company") on Form 10-Q for the quarter ended September 28, 2014 (the "Report"), I, Eric M. DeMarco, Chief Executive Officer of the Company, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

(1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended; and
(2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: November 7, 2014

KRATOS DEFENSE & SECURITY SOLUTIONS, INC.

/s/ ERIC M. DEMARCO

Eric M. DeMarco
Chief Executive Officer, President
(Principal Executive Officer)

EXHIBIT 32.2

CERTIFICATION PURSUANT TO SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002
(18 U.S.C. SECTION 1350)

In connection with the accompanying Quarterly Report of Kratos Defense & Security Solutions, Inc. (the "Company") on Form 10-Q for the quarter ended September 28, 2014 (the "Report"), I, Deanna H. Lund, Chief Financial Officer of the Company, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

(1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended; and
(2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: November 7, 2014

KRATOS DEFENSE & SECURITY SOLUTIONS, INC.

/s/ DEANNA H. LUND

Deanna H. Lund
Executive Vice President, Chief Financial Officer

(Principal Financial Officer and Acting Principal Accounting Officer)