KRATOS DEFENSE & SECURITY SOLUTIONS, INC.
Form 10-Q
May 07, 2015
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

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

For the Quarterly Period Ended March 29, 2015

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

Commission file number 001-34460

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

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

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

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

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

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

Large accelerated filer o	Accelerated filer ý

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

Smaller reporting company o

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

As of May 1, 2015, 53,281,685 shares of the registrant’s common stock were outstanding.

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KRATOS DEFENSE & SECURITY SOLUTIONS, INC.

FORM 10-Q

FOR THE QUARTERLY PERIOD ENDED March 29, 2015

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements.

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

	December 28, 2014	March 29, 2015
Assets		
Current assets:		
Cash and cash equivalents	$34.7	$34.4
Restricted cash	5.4	1.6
Accounts receivable, net	248.2	238.6
Inventoried costs	68.0	72.1
Prepaid expenses	8.5	8.4
Other current assets	10.1	11.1
Total current assets	374.9	366.2
Property, plant and equipment, net	82.6	81.5
Goodwill	596.4	596.4
Intangible assets, net	52.3	47.7
Other assets	32.6	30.8
Total assets	$1,138.8	$1,122.6
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	$48.4	$42.5
Accrued expenses	34.2	31.5
Accrued compensation	46.4	39.2
Accrued interest	5.6	16.5
Billings in excess of costs and earnings on uncompleted contracts	52.1	56.5
Deferred income tax liability	30.3	30.2
Other current liabilities	9.1	6.6
Total current liabilities	226.1	223.0
Long-term debt principal, net of current portion	622.0	622.0
Line of credit	41.0	41.0
Other long-term liabilities	25.4	25.1
Total liabilities	914.5	911.1
Commitments and contingencies		
Stockholders' equity:		
Preferred stock, $0.001 par value, 5,000,000 shares authorized, 0 shares outstanding at December 28, 2014 and March 29, 2015	—	—
Common stock, $0.001 par value, 195,000,000 shares authorized; 57,801,978 and 58,273,919 shares issued and outstanding at December 28, 2014 and March 29, 2015, respectively	—	—
Additional paid-in capital	863.4	867.1
Accumulated other comprehensive loss	(1.7)	(1.9)
Accumulated deficit	(637.4)	(653.7)
Total stockholders' equity	224.3	211.5
Total liabilities and stockholders' equity	$1,138.8	$1,122.6

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

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

	Three Months Ended	
	March 30, 2014	March 29, 2015
Service revenues	$100.6	$87.4
Product sales	99.5	95.1
Total revenues	200.1	182.5
Cost of service revenues	74.1	66.0
Cost of product sales	73.4	69.6
Total costs	147.5	135.6
Gross profit	52.6	46.9
Selling, general and administrative expenses	43.4	42.6
Research and development expenses	5.2	4.8
Unused office space and other restructuring	0.7	1.0
Operating income (loss) from continuing operations	3.3	(1.5)
Other income (expense):		
Interest expense, net	(16.1)	(12.2)
Other income (expense), net	0.2	(0.4)
Total other expense, net	(15.9)	(12.6)
Loss from continuing operations before income taxes	(12.6)	(14.1)
Provision for income taxes from continuing operations	2.3	2.4
Loss from continuing operations	(14.9)	(16.5)
Income (loss) from discontinued operations	(0.1)	0.2
Net loss	$(15.0)	$(16.3)
Basic and diluted loss per common share:		
Net loss from continuing operations	$(0.26)	$(0.28)
Net loss from discontinued operations	0.00	0.00
Net loss per common share	$(0.26)	$(0.28)
Basic and diluted weighted average shares outstanding	57.4	58.3
Comprehensive Loss		
Net loss (from above)	$(15.0)	$(16.3)
Change in cumulative translation adjustment	(0.1)	(0.2)
Comprehensive loss	$(15.1)	$(16.5)

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

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

	Three Months Ended	
	March 30, 2014	March 29, 2015
Operating activities:		
Net loss	$(15.0)	$(16.3)
Less: Income (loss) from discontinued operations	(0.1)	0.2
Loss from continuing operations	(14.9)	(16.5)
Adjustments to reconcile loss from continuing operations to net cash provided by (used in) operating activities from continuing operations:		
Depreciation and amortization	9.6	8.5
Stock-based compensation	1.8	2.0
Deferred income taxes	—	1.8
Amortization of deferred financing costs	1.3	0.5
Amortization of premium and discount on Senior Secured Notes	(1.0)	0.3
Provision for doubtful accounts	0.1	0.1
Changes in unused office space accrual	0.2	—
Changes in assets and liabilities, net of acquisitions:		
Accounts receivable	17.8	9.6
Inventoried costs	(6.7)	(6.0)
Prepaid expenses and other assets	2.2	(1.4)
Accounts payable	(13.7)	(6.4)
Accrued compensation	(6.3)	(7.2)
Accrued expenses	(5.2)	(2.8)
Advance payments received on contracts	—	1.7
Accrued interest payable	15.6	10.9
Billings in excess of costs and earnings on uncompleted contracts	(0.1)	4.4
Income tax receivable and payable	1.8	(0.1)
Other liabilities	(0.8)	(2.3)
Net cash provided by (used in) operating activities from continuing operations	1.7	(2.9)
Investing activities:		
Cash paid for acquisitions, net of cash acquired	(1.6)	—
Decrease in restricted cash	—	3.8
Capital expenditures	(3.1)	(2.2)
Net cash provided by (used in) investing activities from continuing operations	(4.7)	1.6
Financing activities:		
Repayment of debt	(0.2)	(0.2)
Other	1.6	1.7
Net cash provided by financing activities from continuing operations	1.4	1.5
Net cash flows of continuing operations	(1.6)	0.2
Net operating cash flows of discontinued operations	(0.5)	(0.2)
Effect of exchange rate changes on cash and cash equivalents	—	(0.3)
Net decrease in cash and cash equivalents	(2.1)	(0.3)
Cash and cash equivalents at beginning of period	55.7	34.7
Cash and cash equivalents at end of period	$53.6	$34.4

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

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KRATOS DEFENSE & SECURITY SOLUTIONS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

Note 1. Summary of Significant Accounting Policies

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

(a) Basis of Presentation

The information as of March 29, 2015 and for the three months ended March 30, 2014 and March 29, 2015 is unaudited. The condensed consolidated balance sheet as of December 28, 2014 was derived from the Company’s audited consolidated financial statements at that date. In the opinion of management, these unaudited condensed consolidated financial statements include all adjustments, consisting of normal recurring adjustments necessary for a fair presentation of the Company’s financial position, results of operations and cash flows for the interim periods presented. The results have been prepared in accordance with the instructions to Form 10-Q and do not necessarily include all information and footnotes necessary for presentation in accordance with accounting principles generally accepted in the 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 28, 2014, included in the Company’s Annual Report on Form 10-K filed with the U.S. Securities and Exchange Commission ("SEC") on March 13, 2015 (the “Form 10-K”). Interim operating results are not necessarily indicative of operating results expected in subsequent periods or for the year as a whole.

(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 month periods ended March 30, 2014 and March 29, 2015 consisted of 13-week periods, respectively. There are 52 calendar weeks in the fiscal years ending on December 28, 2014 and December 27, 2015.

(d) Accounting Estimates

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

In accounting for our long-term contracts for production of products and services provided to the U.S. Government 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.

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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 January 2015 the FASB issued Accounting Standards Update No. 2015-01 ("ASU 2015-1"), "Income Statement - Extraordinary and Unusual Items (Subtopic 225-20): Simplifying Income Statement Presentation by Eliminating the Concept of Extraordinary Items." ASU 2015-1 eliminates from GAAP the concept of extraordinary items. Subtopic 225-20, Income Statement - Extraordinary and Unusual Items, required that an entity separately classify, present, and disclose extraordinary events and transactions. Presently, an event or transaction is presumed to be an ordinary and usual activity of the reporting entity unless evidence clearly supports its classification as an extraordinary item. The amendments in this ASU are effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2015. The Company does not believe that the adoption of this guidance will have a material impact on its condensed consolidated financial statements.

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 were effective in the first quarter of 2015 for public organizations with calendar year ends. The Company adopted this standard in the quarter ended March 29, 2015, which did not 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, however, a delay in the effective date is currently being considered by the FASB, which we expect will result in at least a one year deferral. 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

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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, other than the adoption of ASU 2014-08, for the three months ended March 29, 2015 as compared to the significant accounting policies described in the Form 10-K.

(f) Fair Value of Financial Instruments

The carrying amounts and the related estimated fair values of the Company's long-term debt financial instruments not measured at fair value on a recurring basis at December 28, 2014 and March 29, 2015 are presented in Note 7. The carrying value of all other financial instruments, including cash equivalents, accounts receivable, accounts payable, accrued expenses, billings in excess of cost and earnings on uncompleted contracts, income taxes payable and short-term debt, approximated their estimated fair values at December 28, 2014 and March 29, 2015 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 28, 2014 and March 29, 2015 by reportable segment are as follows (in millions):

	Public Safety & Security	Kratos Government Solutions	Unmanned Systems	Total
Gross value	$53.9	$678.8	$111.1	$843.8
Less accumulated impairment	18.3	215.3	13.8	$247.4
Net	$35.6	$463.5	$97.3	$596.4

(b) Purchased Intangible Assets

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

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	As of December 28, 2014			As of March 29, 2015		
	Gross Value	Accumulated Amortization	Net Value	Gross Value	Accumulated Amortization	Net Value
Acquired finite-lived intangible assets:						
Customer relationships	$99.0	$(70.6)	$28.4	$99.0	$(74.2)	$24.8
Contracts and backlog	82.7	(80.0)	2.7	82.7	(80.2)	2.5
Developed technology and technical know-how	23.1	(10.9)	12.2	23.1	(11.5)	11.6
Trade names	6.0	(5.0)	1.0	6.0	(5.1)	0.9
Favorable operating lease	1.8	(0.7)	1.1	1.8	(0.8)	1.0
Total finite-lived intangible assets	212.6	(167.2)	45.4	212.6	(171.8)	40.8
Acquired indefinite-lived intangible assets:						
Trade names	6.9	—	6.9	6.9	—	6.9
Total intangible assets	$219.5	$(167.2)	$52.3	$219.5	$(171.8)	$47.7

Consolidated amortization expense related to intangible assets subject to amortization was $5.6 million and $4.6 million for the three months ended March 30, 2014 and March 29, 2015, 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 28, 2014	March 29, 2015
Raw materials	$39.8	$38.6
Work in process	22.3	29.2
Finished goods	4.7	4.9
Supplies and other	2.1	2.1
Subtotal inventoried costs	68.9	74.8
Less: Customer advances and progress payments	(0.9)	(2.7)
Total inventoried costs	$68.0	$72.1

Note 4. Stockholders' Equity

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

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	For the Three Months Ended	
	March 30, 2014	March 29, 2015
Stockholders’ equity at beginning of period	$295.8	$224.3
Comprehensive loss:		
Net loss	(15.0)	(16.3)
Foreign currency translation	(0.1)	(0.2)
Total comprehensive loss	(15.1)	(16.5)
Exercise of stock options and warrants	(0.1)	—
Stock-based compensation	1.8	2.0
Employee stock purchase plan and restricted stock units settled in cash	1.8	1.8
Restricted stock units traded for taxes	(0.1)	(0.1)
Stockholders’ equity at end of period	$284.1	$211.5

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

	March 30, 2014	March 29, 2015
Cumulative translation adjustment	$(0.4)	$(0.9)
Post retirement benefit reserve adjustment net of tax expense	(0.5)	(1.0)
Total accumulated other comprehensive loss	$(0.9)	$(1.9)

There were no reclassifications from other comprehensive income to net loss for the three months ended March 30, 2014 or March 29, 2015.

Common stock issued by the Company for the three months ended March 30, 2014 and March 29, 2015 was as follows (in millions):

	For the Three Months Ended	
	March 30, 2014	March 29, 2015
Shares outstanding at beginning of the period	57.1	57.8
Stock issued for employee stock purchase plan, stock options and restricted stock units exercised	0.3	0.5
Shares outstanding at end of the period	57.4	58.3

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 1.2 million and 2.3 million for the three months ended March 30, 2014 and March 29, 2015, respectively.

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Note 6. Income Taxes

A reconciliation of the 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 income tax provision (benefit) for the three months ended March 30, 2014 and March 29, 2015 is as follows (in millions):

	For the Three Months Ended	
	March 30, 2014	March 29, 2015
Income tax benefit at federal statutory rate	$(4.4)	$(4.9)
State and foreign taxes, net of federal tax benefit and valuation allowance	0.6	0.5
Nondeductible expenses and other	0.6	0.5
Impact of deferred tax liabilities for indefinite-lived assets	1.7	1.8
Increase in reserves for uncertain tax positions	—	0.1
Increase in federal valuation allowance	3.8	4.4
Total income tax provision	$2.3	$2.4

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 months ended March 29, 2015, there was no impact of such limitations on the income tax provision, since the amount of taxable income did not exceed the annual limitation amount. In addition, future equity offerings or acquisitions that have equity as a component of the purchase price could also cause an “ownership change.” If and when any other “ownership change” occurs, utilization of the NOL or other tax attributes may be further limited.

As discussed elsewhere, deferred tax assets relating to the NOL and credit carryforwards are offset by a full valuation allowance. In addition, utilization of state tax loss carryforwards is dependent upon sufficient taxable income apportioned to the states.

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.

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As of December 28, 2014, the Company had $16.4 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 three months ended March 29, 2015, there was no change in the amount of unrecognized tax benefits 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. For the three months ended March 30, 2014, there was no material expense recorded related to interest and penalties. For the three months ended March 29, 2015, the Company recorded an expense for interest and penalties of $0.1 million. For the three months ended March 30, 2014 and March 29, 2015, there was no material benefit recorded related to interest and penalties. The Company believes that no significant amount of the liabilities for uncertain tax positions will expire within twelve months of March 29, 2015.

Note 7. 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 $8.8 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; or (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 March 29, 2015, 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.

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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 March 29, 2015, there was $41.0 million outstanding on the Credit Agreement and $13.1 million was outstanding on letters of credit, resulting in net borrowing base availability of $38.4 million. The Company was in compliance with the financial covenants of the Credit Agreement as of March 29, 2015.

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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 March 29, 2015 was $3.5 million, and the loan is payable in quarterly installments of $0.3 million plus interest at LIBOR plus a margin of 1.5%. The loan agreement contains various covenants, including a minimum net equity covenant as defined in the loan agreement. The Company was in compliance with all covenants, including the minimum net equity covenant, as of March 29, 2015.

Fair Value of Long-term Debt

Carrying amounts and the related estimated fair values of the Company's long-term debt financial instruments not measured at fair value on a recurring basis at December 28, 2014 and March 29, 2015 are presented in the following table:

	As of December 28, 2014			As of March 29, 2015		
$ in millions	Principal	Carrying Amount	Fair Value	Principal	Carrying Amount	Fair Value
Total Long-term debt including current portion	$669.8	$664.0	$577.1	$669.5	$664.0	$591.0

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

The net unamortized original issue discount of $5.5 million as of March 29, 2015, which is the difference between the carrying amount of $664.0 million and the principal amount of $669.5 million presented in the previous table, is being accreted to interest expense over the term of the related debt.

Note 8. Segment Information

The KGS reportable segment is comprised of an aggregation of Kratos' Government Solutions operating segments, including our electronic products, satellite communications, modular systems and defense and rocket support operating segments.

The new US reportable segment consists of our unmanned aerial, ground, seaborne and command, control and communications system business. The KGS and US segments provide products, solutions and services for mission critical national security priorities. KGS and US customers primarily include national security related agencies, the DoD, intelligence agencies and classified agencies, and to a lesser degree, international government agencies and domestic and international commercial customers. The PSS segment designs, engineers, deploys, operates and integrates into command and control infrastructure security and surveillance solutions for homeland security, public safety, critical infrastructure, government and commercial customers. PSS customers are in the critical infrastructure, power generation, power transport, nuclear energy, financial, IT, healthcare, education, transportation and petro-chemical industries, as well as certain government and military customers.

The Company organizes its reportable segments based on the nature of the products, solutions and services offered. Transactions between segments are generally negotiated and accounted for under terms and conditions similar to other government and commercial contracts. This presentation is consistent with the Company's operating structure. In the following table, prior year financial information has been recast to conform to the current reportable segments, and total operating income of the reportable business segments is reconciled to the corresponding consolidated amount. The reconciling item “corporate activities” includes costs for certain stock-based compensation programs (including stock-based compensation costs for stock options, employee stock purchase plan and restricted stock units), the effects of items not considered part of management's evaluation of segment operating performance, merger and acquisition expenses, corporate costs not allocated to the segments, and other miscellaneous corporate activities.

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Revenues, depreciation and amortization, and operating income (loss) generated by the Company's reportable segments for the three month periods ended March 30, 2014 and March 29, 2015 are as follows (in millions):

	Three Months Ended	
	March 30, 2014	March 29, 2015
Revenues:		
Kratos Government Solutions		
Service revenues	$51.7	$49.8
Product sales	79.8	82.7
Total Kratos Government Solutions	131.5	132.5
Public Safety & Security		
Service revenues	48.9	37.6
Product sales	—	—
Total Public Safety & Security	48.9	37.6
Unmanned Systems		
Service revenues	—	—
Product sales	19.7	12.4
Total Unmanned Systems	19.7	12.4
Total revenues	$200.1	$182.5
Depreciation & amortization:		
Kratos Government Solutions	$7.6	$6.8
Public Safety & Security	0.5	0.1
Unmanned Systems	1.5	1.6
Total depreciation and amortization	$9.6	$8.5
Operating income (loss):		
Kratos Government Solutions	$5.9	$4.7
Public Safety & Security	1.0	0.1
Unmanned Systems	(1.8)	(4.1)
Unallocated corporate expense, net	(1.8)	(2.2)
Total operating income (loss)	$3.3	$(1.5)

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Note 9. 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 and US segments have substantial revenue from the U.S. Government. Sales to the U.S. Government amounted to approximately $116.3 million and $112.1 million, or 58% and 61% of total Kratos revenue, for the three months ended March 30, 2014 and March 29, 2015.

Note 10. Commitments and Contingencies

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 government laws and regulations and other matters arising out of the normal conduct of the Company’s 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 disputes are inherently unpredictable and unfavorable resolutions could occur, assessing litigation and legal dispute 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 but not limited to the procedural status of the matter in question, the presence of complex or novel legal theories, and the ongoing discovery and development of information important to the matters. In addition, damage amounts claimed in litigation 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 any such losses, damages or remedies may have 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.

(a) Legal and 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 recent audits of the Company's contracts, the DCAA is closely examining and questioning certain of the established and disclosed practices that it had previously audited and accepted. Costs incurred and allocated to contracts with the U.S. Government are regularly scrutinized for compliance with regulatory standards by the Company's personnel.

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.

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

	Three Months Ended	
	March 30, 2014	March 29, 2015
Balance at beginning of the period	$5.4	$5.3
Costs accrued and revenues deferred	0.4	0.1
Settlements made (in cash or kind) and revenues recognized and other	(0.1)	(0.1)
Balance at end of period	5.7	5.3
Less: Current portion	(5.3)	(5.0)
Non-current accrued product warranty and deferred warranty revenue	$0.4	$0.3

Note 11. Condensed Consolidating Financial Statements

The Company has $625.0 million in outstanding Senior Secured Notes (see Note 7). 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.

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Condensed Consolidating Balance Sheet
December 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	$28.7	$(6.0)	$12.0	$—	$34.7
Accounts receivable, net	—	217.7	30.5	—	248.2
Amounts due from affiliated companies	341.9	—	—	(341.9)	—
Inventoried costs	—	49.9	18.1	—	68.0
Other current assets	4.4	16.3	3.3	—	24.0
Total current assets	375.0	277.9	63.9	(341.9)	374.9
Property, plant and equipment, net	2.0	70.6	10.0	—	82.6
Goodwill	—	572.4	24.0	—	596.4
Intangible assets, net	—	52.2	0.1	—	52.3
Investment in subsidiaries	498.3	48.3	—	(546.6)	—
Amounts due from affiliated companies	—	3.2	—	(3.2)	—
Other assets	27.8	4.6	0.2	—	32.6
Total assets	$903.1	$1,029.2	$98.2	$(891.7)	$1,138.8
Liabilities and Stockholders' Equity					
Current liabilities:					
Accounts payable	$3.1	$40.4	$4.9	$—	$48.4
Accrued expenses	6.3	30.2	3.3	—	39.8
Accrued compensation	5.2	37.7	3.5	—	46.4
Billings in excess of costs and earnings on uncompleted contracts	—	47.0	5.1	—	52.1
Deferred income tax liability	—	30.3	—	—	30.3
Amounts due to affiliated companies	—	306.6	35.3	(341.9)	—
Other current liabilities	1.0	6.5	1.6	—	9.1
Total current liabilities	15.6	498.7	53.7	(341.9)	226.1
Long-term debt, net of current portion	660.2		2.8	—	663.0
Amounts due to affiliated companies	—	—	3.2	(3.2)	—
Other long-term liabilities	3.0	20.2	2.2	—	25.4
Total liabilities	678.8	518.9	61.9	(345.1)	914.5
Total stockholders' equity	224.3	510.3	36.3	(546.6)	224.3
Total liabilities and stockholders' equity	$903.1	$1,029.2	$98.2	$(891.7)	$1,138.8

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Condensed Consolidating Balance Sheet
March 29, 2015
(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	$21.6	$0.4	$12.4	$—	$34.4
Accounts receivable, net	—	209.7	28.9	—	238.6
Amounts due from affiliated companies	347.1	—	—	(347.1)	—
Inventoried costs	—	51.9	20.2	—	72.1
Other current assets	2.9	14.7	3.5	—	21.1
Total current assets	371.6	276.7	65.0	(347.1)	366.2
Amounts due from affiliated companies, long-term	—	3.2	—	(3.2)	—
Property, plant and equipment, net	1.9	69.7	9.9	—	81.5
Goodwill	—	572.4	24.0	—	596.4
Intangible assets, net	—	47.7	—	—	47.7
Investment in subsidiaries	499.4	52.7	—	(552.1)	—
Other assets	27.4	3.3	0.1	—	30.8
Total assets	$900.3	$			