KRATOS DEFENSE & SECURITY SOLUTIONS, INC.
Form 10-Q
November 06, 2008

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 28, 2008

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

Commission file number 0-27231

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.)

4810 Eastgate Mall
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 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 (Check one):

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

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

As of October 31, 2008 105,292,730 shares of the registrant's common stock were outstanding

KRATOS DEFENSE & SECURITY SOLUTIONS, INC.

FORM 10-Q

FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 28, 2008

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

KRATOS DEFENSE & SECURITY SOLUTIONS, INC.

CONSOLIDATED BALANCE SHEETS

(in millions, except par value and number of shares)

(Unaudited)

	December 31, 2007	September 28, 2008
Assets		
Current assets:		
Cash and cash equivalents	$ 8.6	$ 2.5
Restricted cash		1.5
Accounts receivable, net	77.0	90.7
Prepaid expenses	7.4	5.0
Note receivable	2.6	
Other current assets	9.7	8.9
Current assets of discontinued operations	1.6	0.7
Total current assets	106.9	109.3
Property and equipment, net	6.9	7.0
Goodwill	194.5	237.3
Other intangibles, net	19.9	25.0
Investments in unconsolidated affiliates	0.3	
Other assets	6.7	3.9
Non current assets of discontinued operations	0.1	0.3
Total assets	$ 335.3	$ 382.8
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	$ 22.7	$ 16.2
Accrued expenses	14.5	14.5
Accrued compensation	9.9	12.3
Billings in excess of costs and earnings on uncompleted contracts	10.9	7.9
Current portion of long-term debt	2.6	6.3
Other current liabilities	17.6	15.9
Current liabilities of discontinued operations	5.3	4.0
Total current liabilities	83.5	77.1
Long-term debt, net of current portion	72.9	76.4
Deferred tax liabilities	2.0	3.2
Other long-term liabilities	7.0	3.9
Non current liabilities of discontinued operations	2.7	2.2
Total liabilities	168.1	162.8
Commitments and contingencies (Notes 1, 5, 6, 7, 8 and 13)		
Stockholders' equity:		
Preferred Stock, 5,000,000 shares authorized, Series B Convertible Preferred Stock, $.001 par value; 10,000 shares outstanding at December 31, 2007 and September 28, 2008, (liquidation preference $5.0 million)		

Common Stock, $.001 par value, 195,000,000 shares authorized; 78,998,922 shares and 105,130,415 shares issued and outstanding at December 31, 2007 and September 28, 2008, respectively				
Additional paid-in capital		412.7		466.8
Accumulated deficit		(245.5)		(246.8)
Total stockholders' equity		167.2		220.0
Total liabilities and stockholders' equity	$	335.3	$	382.8

See accompanying notes to unaudited financial statements.

KRATOS DEFENSE & SECURITY SOLUTIONS, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS

(in millions, except per share amounts)

(Unaudited)

	Three months ended		Nine months ended	
	September 30, 2007	September 28, 2008	September 30, 2007	September 28, 2008
Revenues	$ 47.5	$ 81.5	$ 144.3	$ 222.0
Cost of revenues	39.3	63.6	121.3	178.6
Gross profit	8.2	17.9	23.0	43.4
Selling, general and administrative expenses	8.9	14.6	28.8	37.7
Research and development		1.0		1.0
Impairment of assets and adjustments to the liability for unused office space	1.2	0.3	1.2	(0.3)
Recovery of unauthorized issuance of stock options and stock option investigation and related fees	6.5	(1.0)	13.0	(1.6)
Operating income (loss)	(8.4)	3.0	(20.0)	6.6
Other income (expense):				
Interest income (expense), net	0.1	(2.7)	0.1	(7.5)
Other income (expense), net		(0.2)	0.7	0.8
Total other income (expense), net	0.1	(2.9)	0.8	(6.7)
Income (loss) from continuing operations before income taxes	(8.3)	0.1	(19.2)	(0.1)
Provision for income taxes	0.4	0.5	0.9	1.4
Loss from continuing operations	(8.7)	(0.4)	(20.1)	(1.5)
Income (loss) from discontinued operations	(4.7)	0.2	(9.2)	0.2
Net loss	$ (13.4)	$ (0.2)	$ (29.3)	$ (1.3)
Basic earnings (loss) per common share:				
Loss from continuing operations	$ (0.12)	$ (0.00)	$ (0.27)	$ (0.02)
Income (loss) from discontinued operations	(0.06)	0.00	(0.13)	0.00
Net loss	$ (0.18)	$ (0.00)	$ (0.40)	$ (0.01)
Diluted earnings (loss) per common share:				
Loss from continuing operations	$ (0.12)	$ (0.00)	$ (0.27)	$ (0.02)
Income (loss) from discontinued operations	(0.06)	0.00	(0.13)	0.00
Net loss	$ (0.18)	$ (0.00)	$ (0.40)	$ (0.01)
Weighted average common shares outstanding:				
Basic	74.1	105.1	74.0	88.0
Diluted	74.1	105.1	74.0	88.0

See accompanying notes to unaudited financial statements.

KRATOS DEFENSE & SECURITY SOLUTIONS, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(in millions)

(Unaudited)

	Nine months ended	
	September 30, 2007	September 28, 2008
Operating activities:		
Net loss	$ (29.3)	$ (1.3)
Income (loss) from discontinued operations	9.2	(0.2)
Loss from continuing operations	(20.1)	(1.5)
Adjustments to reconcile net loss from continuing operations to net cash provided by (used in) continuing operations:		
Depreciation and amortization	3.6	5.5
Provision for doubtful accounts		0.4
Asset impairment	0.2	0.2
Write-off and disposal of fixed assets	0.4	
Mark to market on swaps		0.4
Deferred income taxes	7.0	0.6
Change in accrual for unused office space		(0.6)
Stock-based compensation	0.4	0.8
Changes in assets and liabilities, net of acquisitions and divestitures:		
Accounts receivable	11.8	(0.5)
Prepaid expenses	(0.6)	2.9
Other assets	(6.3)	4.4
Accounts payable	0.1	(9.1)
Accrued expenses	0.6	(0.6)
Accrued compensation	0.9	(1.1)
Billings in excess of costs and earnings on uncompleted contracts	(0.2)	(3.8)
Other liabilities	7.1	(3.4)
Net cash provided by (used in) continuing operations	4.9	(5.4)
Investing activities:		
Cash paid in acquisitions, net	(6.2)	(2.1)
Decrease (increase) in restricted cash	1.0	(1.5)
Proceeds from the disposition of discontinued operations	57.7	0.3
Capital expenditures	(1.1)	(0.7)
Proceeds from the sale of investments		0.3
Net cash provided by (used in) investing activities from continuing operations	51.4	(3.7)
Financing activities:		
Borrowings under line of credit	8.0	6.0
Repayment under line of credit and term notes	(58.0)	(2.0)
Decrease in capital lease obligations	(0.4)	(0.2)
Net cash provided by (used in) financing activities from continuing operations	(50.4)	3.8
Net cash flows of continuing operations	5.9	(5.3)

Cash flows of discontinued operations				
Operating cash flows		(3.6)		(0.8)
Investing cash flows		(1.5)		
Net cash flows of discontinued operations		(5.1)		(0.8)
Net increase (decrease) in cash and cash equivalents		0.8		(6.1)
Cash and cash equivalents at beginning of period		5.4		8.6
Cash and cash equivalents at end of period	$	6.2	$	2.5

See accompanying notes to unaudited financial statements.

KRATOS DEFENSE & SECURITY SOLUTIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

Note 1. Organization and Summary of Significant Accounting Policies

(a)

Description of Business

Kratos Defense & Security Solutions, Inc. ("Kratos" or "the Company") was initially incorporated under the name of Wireless Facilities, Inc. in the state of New York on December 19, 1994, commenced operations in March 1995, and was reincorporated in Delaware in 1998. Under its former name of Wireless Facilities, the Company historically conducted business in three segments: Wireless Network Services, Government Network Services and Enterprise Network Services. The Company was an independent, global provider of outsourced communications and security systems engineering and integration services for the wireless communications industry through its Wireless Network Services division ("WNS"), the U.S. government through its Government Network Services division ("GNS"), and enterprise customers through its Enterprise Network Services division ("ENS").

In 2006 and 2007, the Company undertook a transformation strategy that culminated in the divestiture in 2007 of its wireless-related businesses, and since then the Company has aggressively pursued business with the federal government, primarily the U.S. Department of Defense, through strategic acquisition. See Note 7, Acquisitions. The Company's divestiture of its European wireless engineering services business was completed in March 2007. In addition, the Company's divestiture of its domestic wireless engineering services business was completed in June 2007 and the divestiture of its wireless deployment services business was completed in July 2007. Accordingly, the accompanying financial statements reflect the divestiture of the domestic wireless engineering services and wireless network deployment business and the results of their operations through the date of divestiture as discontinued operations in the accompanying statements of operations.

As a result of the divestiture of the Company's wireless related assets and businesses in 2007, the Company changed its name from Wireless Facilities, Inc. to Kratos Defense & Security Solutions, Inc. on September 12, 2007. The name was changed to reflect the Company's revised focus as a defense contractor and security systems integrator for the federal government and for state and local agencies and reflects the Company's business going forward. Additionally, the former operating segments have been renamed as the Kratos Government Solutions ("KGS") segment, which includes all former government-related business formerly included in the GNS segment, and the Public Safety & Security ("PSS") segment, which includes all enterprise, commercial and other civilian business formerly included in the ENS segment. All financial statements prior to September 12, 2007 were issued under the Company's previous name, Wireless Facilities, Inc.

(b)

Basis of Presentation

The information as of September 28, 2008, and for the three and nine months ended September 28, 2008 and September 30, 2007 is unaudited. The consolidated balance sheet as of December 31, 2007 was derived from the Company's audited consolidated financial statements at that date. In the opinion of management, these unaudited 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 of America. These unaudited consolidated financial statements should be read in conjunction with the consolidated financial statements and the

KRATOS DEFENSE & SECURITY SOLUTIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Note 1. Organization and Summary of Significant Accounting Policies (Continued)

related notes included in the Company's audited annual consolidated financial statements for the year ended December 31, 2007, filed on Form 10-K on March 27, 2008 with the United States Securities and Exchange Commission ("SEC"). Interim operating results are not necessarily indicative of operating results expected in subsequent periods or for the year as a whole.

(c)

Principles of Consolidation

The consolidated financial statements include the accounts of Kratos and its wholly-owned subsidiaries for which all inter-company transactions have been eliminated in consolidation. Kratos and its subsidiaries are collectively referred to herein as the "Company."

Investments in unconsolidated affiliates are accounted for using the cost method as the Company owns less than 20% and the Company has no significant influence over the affiliates.

(d)

Fiscal Calendar

In 2008, the Company changed its fiscal year end to the last Sunday of the year with interim fiscal periods ending on the last Sunday of the last calendar month of each quarter. For fiscal year 2007, the Company's year end was December 31 with fiscal periods ending on the last calendar day of the last month of each quarter.

(e)

Revenue Recognition

The Company provides services to customers under three primary types of contracts: fixed-price; time and materials; and cost reimbursable plus fixed fee. The Company realizes a portion of its revenue from long-term contracts and accounts for these contracts under the provisions of Statement of Position (SOP) 81-1, "Accounting for Performance of Construction-Type and Certain Production-Type Contracts." Revenue on fixed-price contracts is recognized using the percentage-of-completion method of accounting based on the ratio of total costs incurred to date compared to estimated total costs to complete the contract. Estimates of costs to complete include materials, direct labor, overhead, and allowable general and administrative expenses (for government contracts). While the Company generally does not incur a material amount of set-up fees for its projects, such costs, if any, are excluded from the estimated total costs to complete the contract and are expensed as incurred. Cost estimates are reviewed monthly on an individual 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. The full amount of an estimated loss associated with a contract is accrued and charged to operations in the period it is determined that it is probable a loss will be realized from the performance of the contract.

Significant management judgments and estimates, including the estimated costs to complete projects, which determine the project's percentage of completion and profit margin must be made and used in connection with the revenue recognized in any accounting period. In the future, the Company may realize actual results that differ from current estimates and the differences could be material. Accordingly, the revenue the Company recognizes in a given financial reporting period depends on (1) the costs the Company has incurred for individual projects, (2) the Company's then current estimate of the total remaining costs to complete the individual projects and (3) current estimated contract value associated with the projects. If, in any period, the Company significantly increases or decreases the estimate of the total costs to complete a project, and/or reduces or increases the

KRATOS DEFENSE & SECURITY SOLUTIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Note 1. Organization and Summary of Significant Accounting Policies (Continued)

associated contract value, revenue for that period would be impacted. To the extent that the Company's estimates fluctuate over time or differ from actual results, gross margins in subsequent periods may vary significantly from previous estimates. Material differences may result in the amount and timing of the Company's revenue for any period if management made different judgments or utilized different estimates. In the event the Company is unable to provide reliable cost estimates on a given project, the Company records revenue using the completed contract method. There are no contracts for which the Company utilized the completed contract method for the periods ended September 30, 2007 and September 28, 2008.

Under the terms of substantially all of the Company's fixed price contracts, if a contract is terminated without proper cause by the customer, the customer creates unplanned/unreasonable time delays, or the customer modifies the contract tasks/scope, the Company has contractual rights to reimbursement in accordance with the terms and conditions regarding payment for work performed, but not yet billed (i.e., unbilled trade accounts receivable) at a gross profit margin that is consistent with the overall project margin. Furthermore, certain additional provisions compensate the Company for additional or excess costs incurred, whereby any scope reductions or other modifications are subject to reimbursement of costs incurred to date with a reasonable profit margin based on the contract value and completed work at that time. The inherent aforementioned risks are reflected in the Company's ongoing periodic assessment of the "total contract value" and the associated revenue recognized. Total net unbilled accounts receivable at December 31, 2007 and September 28, 2008 were $34.2 million and $42.9 million, respectively. The Company periodically performs work under authorizations to proceed or work orders from its customers for which a formal purchase order may not be received until after the work has commenced. As of December 31, 2007 and September 28, 2008, approximately $0.4 million and $0.6 million, respectively, of the Company's unbilled accounts receivable balance were under an authorization to proceed or work order from its customers where a formal purchase order had not yet been received.

Revenue from certain time and materials and fixed-price contracts are recognized when realized or realizable and earned, in accordance with Staff Accounting Bulletin (SAB) 104 (recognized when services are rendered at contracted labor rates, when materials are delivered and when other direct costs are incurred). Additionally, based on management's periodic assessment of the collectibility of its accounts receivable, credit worthiness and financial condition of customers, the Company determines if collection is reasonably assured prior to the recognition of revenue.

Cost reimbursable contracts for the government provide for reimbursement of costs plus the payment of a fee. The Company records the fee as costs are incurred. Under time and materials contracts, the Company is reimbursed for labor hours at negotiated hourly billing rates and is reimbursed for travel and other direct expenses at actual costs plus applied general and administrative expenses. Under certain of the Company's contractual arrangements, the Company may also recognize revenue for out-of-pocket expenses in accordance with EITF 01-14 "Income Statement Characterization of Reimbursements Received for Out-of-Pocket Expenses Incurred." Depending on the contractual arrangement, these expenses may be reimbursed with or without a fee.

Under certain of its contracts, the Company provides supplier procurement services and materials for its customers. The Company records revenue on these arrangements on a gross or net basis in accordance with EITF 99-19, "Reporting Revenue Gross as a Principal versus Net as an Agent,"

KRATOS DEFENSE & SECURITY SOLUTIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Note 1. Organization and Summary of Significant Accounting Policies (Continued)

depending on the specific circumstances of the arrangement. The Company considers the following criteria, among others, for recording revenue on a gross or net basis:

(1) whether the Company acts as a principal in the transaction;

(2) whether the Company takes title to the products;

(3) whether the Company assumes risks and rewards of ownership, such as risk of loss for collection, delivery or returns;

(4) whether the Company serves as an agent or broker, with compensation on a commission or fee basis.

The Company also recognizes revenue from the sale of hardware, hardware products which include software that is more than incidental, hardware and software maintenance agreements, and Application Service Provider (ASP) services. The Company recognizes revenue when persuasive evidence of an arrangement exists, delivery has occurred or services have been provided, the sale price is fixed or determinable, and collection is reasonably assured.

(f) Inventory

Inventories that are comprised primarily of supplies including parts and materials are stated at the lower of cost or market. The Company regularly reviews inventory quantities on hand, future purchase commitments with its suppliers, and the estimated utility of its inventory. If the Company review indicates a reduction in utility below carrying value, it reduces its inventory to a new cost basis. As of December 31, 2007 and September 28, 2008, the Company had $2.1 million and $2.9 million, respectively, of inventories which were reflected in other current assets on the Consolidated Balance Sheets.

(g) Use of Estimates

The preparation of financial statements in conformity with Generally Accepted Accounting Principles in the United States (US GAAP) requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Such estimates include revenue recognition, allowance for doubtful accounts, valuation of long-lived assets including identifiable intangibles and goodwill, accounting for income taxes including the related valuation allowance on the deferred tax asset, accruals for partial self-insurance, contingencies and litigation and contingent acquisition consideration. In the future, the Company may realize actual results that differ from the current reported estimates and if the estimates that we have 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.

(h) Liquidity

The Company currently carries a significant amount of debt and as such, its ability to execute on additional business opportunities may be limited due to its existing borrowing capacity. In addition, given the relatively highly leveraged liquidity position, any down-turn in its operating earnings could impair its ability to comply with the financial covenants of its existing credit facility. If the Company

KRATOS DEFENSE & SECURITY SOLUTIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Note 1. Organization and Summary of Significant Accounting Policies (Continued)

believed a covenant violation is more than likely to occur in the near future, it would seek relief from its lenders. This relief would have some cost to the Company and such relief might not be on terms as favorable as those in its existing Credit Agreement. If the Company were to actually default due to its failure to meet the financial covenants of its Credit Agreement and inability to obtain a waiver from the lenders, the Company's Credit Agreement could require the Company to immediately repay all amounts then outstanding under the Credit Agreement and/or require the Company to pay interest at default rates per the Credit Agreement. In the event the Company was required to repay the amount outstanding under the existing credit facility, it would need to obtain alternative sources of financing to continue its operating activities at existing levels. There can be no assurance that alternative financing would be available on acceptable terms or at all.

Note 2. Recent Accounting Pronouncements

New Accounting Standards Adopted

In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements," (SFAS 157) which is effective for fiscal years beginning after November 15, 2007 and for interim periods within those years. This statement defines fair value, establishes a framework for measuring fair value and expands the related disclosure requirements. This statement applies under other accounting pronouncements that require or permit fair value measurements. The statement indicates, among other things, that a fair value measurement assumes that the transaction to sell an asset or transfer a liability occurs in the principal market for the asset or liability or, in the absence of a principal market, the most advantageous market for the asset or liability. SFAS 157 defines fair value based upon an exit price model. Relative to SFAS 157, the FASB issued FASB Staff Positions (FSP) 157-1, 157-2, and proposed 157-c. FSP 157-1 amends SFAS 157 to exclude SFAS 13 and its related interpretive accounting pronouncements that address leasing transactions, while FSP 157-2 delays the effective date of SFAS 157 for all nonfinancial assets and nonfinancial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis. FSP 157-c clarifies the principles in SFAS 157 on the fair value measurement of liabilities. The Company adopted SFAS 157 as of January 1, 2008, with the exception of the application of the statement to non-recurring nonfinancial assets and nonfinancial liabilities. Refer to Note 9 to the Consolidated Financial Statements for additional discussion on fair value measurements.

In February 2007, the FASB issued SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement No. 115," (SFAS 159) which is effective for fiscal years beginning after November 15, 2007. This statement permits entities to choose to measure many financial instruments and certain other items at fair value. This statement also establishes presentation and disclosure requirements designed to facilitate comparisons between entities that choose different measurement attributes for similar types of assets and liabilities. Unrealized gains and losses on items for which the fair value option is elected would be reported in earnings. The Company has adopted SFAS 159 as of January 1, 2008 and has elected not to measure any additional financial instruments or other items at fair value.

KRATOS DEFENSE & SECURITY SOLUTIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Note 2. Recent Accounting Pronouncements (Continued)

Future Adoption of Accounting Standards

In December 2007, the FASB issued SFAS No. 141 (revised 2007), "Business Combinations" (SFAS 141(R)), which replaces SFAS No. 141, "Business Combinations." SFAS 141(R) retains the underlying concepts of SFAS 141 in that all business combinations are still required to be accounted for at fair value under the acquisition method of accounting, but SFAS 141(R) changed the method of applying the acquisition method in a number of significant aspects. Acquisition costs will generally be expensed as incurred; noncontrolling interests will be valued at fair value at the acquisition date; in-process research and development will be recorded at fair value as an indefinite-lived intangible asset at the acquisition date; restructuring costs associated with a business combination will generally be expensed subsequent to the acquisition date; and any adjustments to an entity's deferred tax assets and uncertain tax positions that occur after the measurement period will be recorded as a component of income tax expense. SFAS 141(R) is effective on a prospective basis for all business combinations for which the acquisition date is on or after the beginning of the first annual period subsequent to December 15, 2008. Additionally, SFAS 141 (R) is effective for changes to valuation allowances or acquired uncertain tax positions occurring after the effective date of SFAS 141 (R), where the acquisition date occurs prior to the effective date for SFAS 141(R). Early adoption is not permitted. The Company is currently evaluating the effects, if any, that SFAS 141(R) may have on its financial statements; however, since the Company has significant acquired deferred tax assets for which full valuation allowances were recorded at the acquisition date, SFAS 141(R) could significantly affect the results of operations if changes in the valuation allowances occur subsequent to adoption. For additional discussion on deferred tax valuation allowances, refer to Note 10 to the Consolidated Financial Statements in our Annual Report filed on Form 10-K for the fiscal year ended December 31, 2007.

In December 2007, the FASB issued SFAS No. 160, "Noncontrolling Interests in Consolidated Financial Statements an amendment of ARB No. 51." This statement is effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008, with earlier adoption prohibited. This statement requires the recognition of a noncontrolling interest (minority interest) as equity in the consolidated financial statements and separate from the parent's equity. The amount of net income attributable to the noncontrolling interest will be included in consolidated net income on the face of the income statement. It also amends certain of ARB No. 51's consolidation procedures for consistency with the requirements of SFAS 141(R). This statement also includes expanded disclosure requirements regarding the interests of the parent and its noncontrolling interest. The Company is currently evaluating this new statement and anticipates that the statement will not have a significant impact on the Company's results of operations, financial condition or liquidity.

In December 2007, the EITF issued Issue No. 07-1, "Accounting for Collaborative Arrangements." This Issue is effective for financial statements issued for fiscal years beginning after December 15, 2008 and interim periods within those fiscal years, and shall be applied retrospectively to all prior periods presented for all collaborative arrangements existing as of the effective date. This Issue requires that transactions with third parties (i.e., revenue generated and costs incurred by the partners) should be reported in the appropriate line item in each company's financial statement pursuant to the guidance in EITF Issue No. 99-19, "Reporting Revenue Gross as a Principal versus Net as an Agent." This Issue also includes enhanced disclosure requirements regarding the nature and purpose of the arrangement,

KRATOS DEFENSE & SECURITY SOLUTIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Note 2. Recent Accounting Pronouncements (Continued)

rights and obligations under the arrangement, accounting policy, amount and income statement classification of collaboration transactions between the parties. The Company is currently evaluating this new statement and anticipates that the statement will not have a significant impact on the Company's results of operations, financial condition or liquidity.

In March 2008, the FASB issued SFAS No. 161, "Disclosures about Derivative Instruments and Hedging Activities, an amendment of FASB Statement No. 133" (SFAS 161). This statement is intended to improve transparency in financial reporting by requiring enhanced disclosures of an entity's derivative instruments and hedging activities and their effects on the entity's financial position, financial performance, and cash flows. SFAS 161 applies to all derivative instruments within the scope of SFAS 133, "Accounting for Derivative Instruments and Hedging Activities" (SFAS 133) as well as related hedged items, bifurcated derivatives, and nonderivative instruments that are designated and qualify as hedging instruments. Entities with instruments subject to SFAS 161 must provide more robust qualitative disclosures and expanded quantitative disclosures. SFAS 161 is effective prospectively for financial statements issued for fiscal years and interim periods beginning after November 15, 2008, with early application permitted. The Company is currently evaluating the disclosure implications of this statement and anticipates that the statement will not have a significant impact on the Company's results of operations, financial condition or liquidity.

In April 2008, the FASB issued FSP FAS No. 142-3, which amends the factors that must be considered in developing renewal or extension assumptions used to determine the useful life over which to amortize the cost of a recognized intangible asset under FAS No. 142, "Goodwill and Other Intangible Assets." The FSP requires an entity to consider its own assumptions about renewal or extension of the term of the arrangement, consistent with its expected use of the asset, and is an attempt to improve consistency between the useful life of a recognized intangible asset under FAS No. 142 and the period of expected cash flows used to measure the fair value of the asset under FAS No. 141, "Business Combinations." The FSP is effective for fiscal years beginning after December 15, 2008, and the guidance for determining the useful life of a recognized intangible asset must be applied prospectively to intangible assets acquired after the effective date. The FSP is not expected to have a significant impact on the Company's results of operations, financial condition or liquidity.

In May 2008, the FASB issued Financial Accounting Standard (FAS) No. 162, "The Hierarchy of Generally Accepted Accounting Principles." The statement is intended to improve financial reporting by identifying a consistent hierarchy for selecting accounting principles to be used in preparing financial statements that are prepared in conformance with generally accepted accounting principles. Unlike Statement on Auditing Standards (SAS) No. 69, "The Meaning of Present in Conformity With GAAP," FAS No. 162 is directed to the entity rather than the auditor. The statement is effective 60 days following the SEC's approval of the Public Company Accounting Oversight Board (PCAOB) amendments to AU Section 411, "The Meaning of Present Fairly in Conformity with GAAP," and is not expected to have any impact on the Company's results of operations, financial condition or liquidity.

In June 2008, the Financial Accounting Standards Board (FASB) issued FASB Staff Position (FSP) Emerging Issues Task Force (EITF) No. 03-6-1, "Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities." Under the FSP, unvested share-based payment awards that contain rights to receive nonforfeitable dividends (whether paid or unpaid) are

KRATOS DEFENSE & SECURITY SOLUTIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Note 2. Recent Accounting Pronouncements (Continued)

participating securities, and should be included in the two-class method of computing EPS. The FSP is effective for fiscal years beginning after December 15, 2008, and interim periods within those years, and is not expected to have a significant impact on the Company's results of operations, financial condition or liquidity.

Note 3. Stockholders' Equity

The Company has the following three stock option plans under which shares were available for grant at September 28, 2008: the 1999 Equity Incentive Plan (the "1999 Plan"), the 2000 Non-Statutory Stock Option Plan (the "2000 Plan") and the 2005 Equity Incentive Plan (the "2005 Plan"). The Company uses a standard Restricted Stock Unit Agreement (the "RSU Agreement") to govern the issuance of restricted stock units ("RSU") to executive officers under the 2005 Plan.

The following table summarizes the Company's Restricted Stock Unit activity:

	Restricted Stock Units	Weighted-Average Grant-Date Fair Value
	(Shares in Thousands)	
Nonvested balance, December 31, 2007	2,156	$ 2.28
Granted	810	2.05
Vested	(82)	1.96
Nonvested balance, September 28, 2008	2,884	$ 2.21

The following table shows the amounts recognized in the financial statements for the three and nine months ended September 30, 2007 and September 28, 2008 for share-based compensation expense related to employees (in millions, except per share data). The share-based compensation expense for the three and nine months ended September 30, 2007 and September 28, 2008 primarily relates to the grant of restricted stock units. In addition, for the three and nine months ended September 30, 2007

KRATOS DEFENSE & SECURITY SOLUTIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Note 3. Stockholders' Equity (Continued)

and September 28, 2008, there was no incremental tax benefit from stock options exercised in the period.

	For the Three Months Ended		For the Nine Months Ended	
	September 30, 2007	September 28, 2008	September 30, 2007	September 28, 2008
Cost of revenues	$	$	$	$
Selling, general and administrative	0.1	0.4	0.4	0.8
Total cost of employee share-based compensation included in income (loss) from continuing operations, before income tax	0.1	0.4	0.4	0.8
Amount of income tax recognized in earnings				
Amount charged against income from continuing operations	0.1	0.4	0.4	0.8
Amount charged against income (loss) from discontinued operations	0.3		0.7	
Total charged against income	$ 0.4	$ 0.4	$ 1.1	$ 0.8
Total impact on net income (loss) per common share:				
Basic	$ (0.01)	$	$ (0.01)	$ (0.01)
Diluted	$ (0.01)	$	$ (0.01)	$ (0.01)

A summary of the changes in Stockholders' Equity for the periods ended September 30, 2007 and September 28, 2008 is provided below (in millions):

	Nine Months Ended September 30, 2007	Nine Months Ended September 28, 2008
Stockholders' equity, beginning of period	$ 187.1	$ 167.2
Stock based compensation and Employee Stock Purchase Plan	1.1	0.8
Working capital adjustment for acquisition		2.2
Cumulative effect adjustment upon adoption of FIN No. 48	(0.1)	
Additional paid-in-capital for acquisition		51.1
Net loss	(29.3)	(1.3)
Stockholders' equity, end of period	$ 158.8	$ 220.0

The Company has two classes of stock outstanding, Series B Convertible Preferred Stock and common stock. There was no issuance, redemption or conversion of the Series B Convertible Preferred Stock in the most recent fiscal year ended December 31, 2007 or for the period ended September 28,

KRATOS DEFENSE & SECURITY SOLUTIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Note 3. Stockholders' Equity (Continued)

2008. Common stock issued by the Company for the most recent fiscal year ended December 31, 2007 and through the period ended September 28, 2008 was as follows (in millions):

	Year ended December 31, 2007	Nine Months Ended September 28, 2008
Shares outstanding at the beginning of the period	73.9	79.0
Common stock issued for acquisitions	4.6	26.1
Stock based compensation	0.4	
Stock options exercised	0.1	
Shares outstanding at the end of the period	79.0	105.1

The Company has an Employee Stock Purchase Plan ("ESPP") which was approved in 1999 and subsequently suspended effective January 1, 2006. The Company reactivated the ESPP on April 1, 2008.

Note 4. Net Income (Loss) Per Common Share

The Company calculates net income (loss) per share in accordance with SFAS No. 128, "Earnings Per Share". Under SFAS No. 128, basic net income (loss) per common share is calculated by dividing net income (loss) by the weighted-average number of common shares outstanding during the reporting period. Diluted net income (loss) per common share reflects the effects of potentially dilutive securities (in millions).

	For the Three Months Ended		For the Nine Months Ended	
	September 30, 2007	September 28, 2008	September 30, 2007	September 28, 2008
Anti-dilutive weighted shares from restricted stock units and stock options excluded from calculation	7.7	7.7	11.5	8.6
Anti-dilutive weighted shares from preferred stock excluded from calculation	1.0	1.0	1.0	1.0
Anti-dilutive weighted shares of common stock contingently issuable		3.0		3.0
Anti-dilutive weighted shares of common stock from convertible debt		1.1		0.4

Note 5. Income Taxes

The Company adopted the provisions of Financial Accounting Standards Board Interpretations ("FIN 48") on January 1, 2007. The total liability for unrecognized tax benefits as of the date of adoption was $4.7 million. Additionally, the Company has a tax refund claim of $2.4 million for which it has not recorded any benefit under FIN 48 or prior standards. As a result of the implementation of FIN 48, the Company recognized a $0.7 million increase in the liability for unrecognized tax benefits, with $0.2 million net decrease in valuation allowance, $0.1 million charged to retained earnings, and $0.4 million recorded to goodwill. In addition, the Company reduced its gross deferred tax assets by $10.8 million for unrecognized tax benefits, which was offset by a reduction in its valuation allowance by the same amount.

KRATOS DEFENSE & SECURITY SOLUTIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Note 5. Income Taxes (Continued)

As of December 31, 2007, the Company had $15.2 million of unrecognized tax benefits. During the first quarter of 2008, this amount was reduced by $1.2 million relating to the expiration of statutes of limitations resulting in unrecognized tax benefits at March 31, 2008 of $14.0 million. The reduction in unrecognized tax benefits was recorded as a tax benefit from discontinued operations for $1.1 million and a reduction to goodwill for $0.1 million. As of September 28, 2008, the Company had $13.7 million of unrecognized tax benefits. The Company recognizes interest and penalties related to unrecognized tax benefits in its provision for income taxes.

The Company believes that it is reasonably possible that as much as $3.2 million of the FIN 48 tax liabilities will expire within 12 months of September 28, 2008 due to the expiration of various applicable statutes of limitations and possible settlement of a pending income tax refund claim.

The negative tax rate of 1,400% for the nine month period ended September 28, 2008 is a function of the relationship between certain minimum taxes that the Company is subject to regardless of its reported book income.

The Company is subject to taxation in the U.S. and various state tax jurisdictions. The Company's tax years for 2000 and forward are subject to examination by the U.S. and state tax authorities due to the existence of net operating loss carryforwards. Generally, the Company's tax years for 2002 and forward are subject to examination by various foreign tax authorities.

In assessing the realizability of 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 its deferred tax assets, with the exception of an amount equal to its deferred tax liabilities which can be expected to reverse. Management will continue to evaluate the necessity to maintain a valuation allowance against its net deferred tax asset.

Note 6. Significant Transactions

On December 28, 2006, the Board of Directors of the Company approved a plan to divest portions of the Company's business where critical mass had not been achieved. This plan involved the divestiture of the Company's EMEA (Europe, Middle East and Asia) operations and its remaining South American operations. The Company determined that these operations met the criteria to be classified as held for sale. Accordingly, these operations were reflected as discontinued in accordance with SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets" in the accompanying consolidated financial statements.

The EMEA operations were sold to LCC International, Inc. (LCC) on March 9, 2007 for $4.0 million in cash, $3.3 million of which was received on that date. The Company also received approximately $1.8 million from its EMEA operations, prior and subsequent to the closing date as payment on outstanding intercompany debt. The sale of EMEA generated a gain on disposition of $3.3 million. The balance of the $0.7 million sales price was withheld as security for the satisfaction of certain indemnification obligations and was payable on March 31, 2008. In the fourth quarter of 2007, the Company recorded a reserve of $0.7 million on the remaining sales price holdback based on the Company's assessment of LCC's available liquidity and ability to pay following the Company's review of

KRATOS DEFENSE & SECURITY SOLUTIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Note 6. Significant Transactions (Continued)

LCC's most recently filed financial statements, thereby reducing the net estimated gain on this transaction to $2.6 million. In May 2008, the Company and LCC reached an agreement related to the $0.7 million holdback amount, under which LCC agreed to pay the Company the outstanding balance in $100,000 increments each month commencing June 30, 2008. The Company did not receive the payments due on June 30, 2008 or any month thereafter through September 28, 2008. While the Company intends to vigorously pursue collection of the amounts, there is a substantial likelihood the Company will not receive payment of the amount due in light of LCC's apparent current available liquidity.

On April 20, 2007, the Company entered into an Equity Purchase Agreement to sell all of the issued and outstanding equity of its interests of its wholly owned subsidiary WFI Brazil Techlogia en Telecomunicaciones LTDA, to Strategic Project Services, LLC (SPS). The consideration included the assumption of substantially all outstanding liabilities of WFI Brazil, nominal cash consideration, and additional earn-out consideration based on 25 percent of net receivables collected subsequent to the closing date. With respect to the additional earn-out consideration, the Company has not received and does not expect to receive any payments. The Company recorded an impairment charge of approximately $5.2 million as of December 31, 2006 to reduce the current carrying value of the Brazil operations to their estimated fair value based upon indications of interest at that time. In the second quarter of 2007, when this business was sold, a gain on disposition of $0.2 million was recorded primarily due to lower than expected selling costs.

On May 29, 2007, the Company entered into an Asset Purchase Agreement with LCC pursuant to which the Company agreed to sell to LCC all of the assets used in the conduct of the operation of the Company's Wireless Network Services business segment that provided engineering services to the non-government wireless communications industry in the United States.

The transaction was completed on June 4, 2007. The aggregate consideration paid by LCC in connection with the Acquisition was $46 million. LCC delivered a subordinated promissory note for the principal amount of $21.6 million (the "*Subordinated Promissory Note*"), paid $17 million at closing and paid final working capital adjustments of $2.4 million through an amendment to the Subordinated Promissory Note, and the Company retained an estimated $5.0 million in net working capital of the business.

On July 5, 2007, the Company sold the $21.6 million subordinated promissory note taken in the sale of assets to LCC in exchange for approximately $19.6 million in net cash proceeds, reflecting a discount from par value of less than five percent and aggregate transaction fees of approximately $1 million. The note was acquired by a fund affiliated with Silver Point Capital, L.P. The Company collected $2.3 million in January 2008, net of a $0.1 million discount from Silver Point in accordance with the terms of the note agreement for the working capital portion of the note. The Company did not provide any guaranty for LCC's payment obligations for the note.

On July 24, 2007, the Company completed the sale to an affiliate of Platinum Equity of its wireless deployment services portion of the Wireless Network Services segment and the Wireless Facilities trade and corporate names. The total consideration for the acquisition was $24 million including $18 million in cash at closing, subject to typical post-closing working capital adjustments, and an aggregate $6 million in a three-year earn-out arrangement. The Company provided certain transition services to

KRATOS DEFENSE & SECURITY SOLUTIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Note 6. Significant Transactions (Continued)

Platinum Equity for a period of nine months pursuant to a Transition Services Agreement. Under an employee leasing arrangement with Platinum Equity, the Company serviced the payroll for the deployment business employees until October 1, 2007. On September 25, 2007, in accordance with the acquisition agreement, the Company provided its working capital calculation to Platinum Equity. On July 16, 2008, the Company came to an agreement with Platinum Equity on a working capital adjustment of $5.0 million. In connection with that resolution, the earn-out arrangement was terminated. The adjustment is to be paid in installments with the first amount of $2.5 million due on July 31, 2008 and payments of $0.5 million monthly thereafter until paid in full in December 2008. The Company did not make the scheduled $2.5 million payment due as of July 31, 2008. Payments of $1.0 million were made in August and September of 2008, respectively. As of September 28, 2008, the balance of $3.0 million plus accrued interest on the outstanding balance has been reflected in other current liabilities.

The Company determined that the U.S. engineering and U.S. deployment operations met the criteria to be classified as held for sale in the first quarter of 2007. Accordingly, the Company reflected these operations as discontinued and assessed these assets for impairment in accordance with SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets". The Company determined that the assets of the U.S. deployment operations were impaired and recorded an impairment charge of approximately $13.4 million. The fair value of the assets was determined by utilizing the sale price less estimated costs to sell the business. The Company subsequently recorded a gain in discontinued operations from the sale of the U.S. engineering operations of $14.8 million. Upon the divestiture of the deployment business, the Company recorded a loss from disposal of $1.9 million, reflecting the closing working capital adjustment and final closing balance sheet. In addition, the Company recorded a charge for an excess facility accrual of approximately $1.1 million related to certain facility leases of deployment field offices that were not assumed by Platinum.

The determination that the U.S. engineering business and U.S. deployment operations met the criteria to be classified as held for sale in the first quarter of 2007 was also a triggering event under SFAS 142 Goodwill and Other Intangible Assets ("SFAS 142") that resulted in an accelerated review of the Company's goodwill and intangibles assets with indefinite lives. In accordance with SFAS 142, the Company allocated the goodwill for the WNS reporting unit based upon the fair value of the engineering business and the deployment business. The fair values used were based upon market information obtained as a result of the sale of the businesses. This resulted in an impairment charge of approximately $7.2 million related to goodwill for this reporting unit which was recorded in the first quarter of 2007.

In addition, in accordance with EITF 87-24, *Allocation of Interest to Discontinued Operations* ("EITF 87-24"), interest expense incurred on the debt that was required to be repaid as a result of the sales of our wireless network services business was allocated to discontinued operations for the periods presented. During the quarter ended September 30, 2007 and September 28, 2008, interest expense allocated to discontinued operations was approximately $0.1 million and zero, respectively. For the nine months ended September 30, 2007 and September 28, 2008, interest expense allocated to discontinued operations was approximately $2.2 million and zero, respectively. For the nine months ended September 28, 2008, the primary activity related to discontinued operations was a reduction in tax contingencies net of a charge for impairment of assets and the adjustment related to the agreement of

KRATOS DEFENSE & SECURITY SOLUTIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Note 6. Significant Transactions (Continued)

the working capital with Platinum Equity. The following table presents the results of discontinued operations (in millions):

	For the Three Months Ended		For the Nine Months Ended	
	September 30, 2007	September 28, 2008	September 30, 2007	September 28, 2008
Revenue	$ 6.1	$	$ 85.7	$
Net income (loss) before taxes	$ (4.4)	$	$ (10.0)	$ (0.9)
Provision (benefit) for income taxes	0.3	(0.2)	(0.8)	(1.1)
Net income (loss) after taxes	$ (4.7)	$ 0.2	$ (9.2)	$ 0.2

The following is a summary of the assets and liabilities of discontinued operations as of December 31, 2007 and September 28, 2008 (in millions):

	December 31, 2007	September 28, 2008
Cash	$ 0.3	$ 0.1
Accounts receivable, net	0.8	
Other current assets	0.5	0.6
Current assets of discontinued operations	$ 1.6	$ 0.7
Other non-current assets	$ 0.1	$ 0.3
Non-current assets of discontinued operations	$ 0.1	$ 0.3
Accounts payable	$	$ 0.1
Accrued expenses	3.7	2.9
Income tax contingencies	1.2	0.6
Other current liabilities	0.4	0.4
Current liabilities of discontinued operations	$ 5.3	$ 4.0
Non-current income tax contingencies	$ 2.0	$ 1.7
Other non-current liabilities	0.7	0.5
Non-current liabilities of discontinued operations	$ 2.7	$ 2.2

KRATOS DEFENSE & SECURITY SOLUTIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Note 7. Acquisitions

The following tables summarize the changes in the carrying amounts of goodwill and other finite-life intangible assets for the nine months ended September 28, 2008 (in millions):

	Government Network Services
Goodwill	
Balance as of December 31, 2007	$ 194.5
Acquisition of SYS	40.1
Purchase accounting adjustments	2.7
Balance as of September 28, 2008	$ 237.3

	December 31, 2007			September 28, 2008		
	Gross Value	Accumulated Amortization	Net Value	Gross Value	Accumulated Amortization	Net Value
Intangible Assets						
Acquired finite-lived intangible assets						
Customer relationships	$ 15.0	$ (2.6)	$ 12.4	$ 16.3	$ (2.7)	$ 13.6
Contracts and backlog	11.6	(4.2)	7.4	12.0	(5.9)	6.1
Non-compete agreements	1.4	(1.3)	0.1	3.5	(3.1)	0.4
Intellectual property	0.4	(0.4)		5.3	(0.4)	4.9
Total	$ 28.4	$ (8.5)	$ 19.9	$ 37.1	$ (12.1)	$ 25.0

Consolidated amortization expense related to intangible assets subject to amortization was $0.7 million and $1.3 million for the quarters ended September 30, 2007 and September 28, 2008, respectively. Consolidated amortization expense related to intangible assets subject to amortization was $2.1 million and $3.6 million for the nine months ended September 30, 2007 and September 28, 2008, respectively.

On June 28, 2008, the Company acquired San Diego-based SYS Technologies ("SYS"). SYS provides a range of Command, Control, Communications, Computers, Combat Systems, Intelligence, Surveillance, and Reconnaissance (C5ISR) and net-centric solutions to federal, state, local and other customers. The combination of SYS and Kratos creates a broad, complementary set of offerings, and positions the organization to deliver proven capabilities to a wider spectrum of customers in the areas of highly-specialized engineering and IT solutions and services, specifically in the areas of weapon systems life cycle support and extension, military range operations, missile and weapon system testing, and C5ISR. The amount of goodwill assigned in the preliminary allocation of purchase price is primarily attributable to the aforementioned advantages of this acquisition. Further, goodwill assigned to this transaction has not yet been allocated to the Company's reportable segments.

The purchase price of $55.7 million includes direct transaction costs of $2.5 million and estimated restructuring costs to be paid by Kratos. The value of the purchase price related to the common stock issued was derived from the number of shares of Kratos common stock issued of 25.3 million, based on 20.1 million shares of SYS common stock outstanding and the exchange ratio of 1.2582 for each SYS

KRATOS DEFENSE & SECURITY SOLUTIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Note 7. Acquisitions (Continued)

share, at a price of $2.022 per share, the average closing price of Kratos shares of common stock for the two days prior to, including, and two days subsequent to the public announcement of the merger on February 21, 2008. Since signing the definitive merger agreement in February 2008, senior management of Kratos and SYS has been developing a plan to restructure and/or exit certain business activities of SYS. The plan includes a comprehensive assessment of personnel, relocation of personnel, facility consolidation and exit strategies for certain lines of business. As of September 28, 2008, the plan tentatively estimates approximately $1.3 million of restructuring costs associated with personnel, and additional costs of $0.4 million for facilities consolidation. Personnel, facilities consolidation and exit costs are still being developed therefore, the estimated restructuring liabilities are subject to change as plans become finalized. The Company expects to finalize the restructuring plan as soon as possible, but no later than June 28, 2009.

The Consolidated Statement of Operations for the three and nine month periods ended September 28, 2008 includes the results of SYS's operations from the date of acquisition.

The following summarizes the preliminary allocation of the purchase price, including transaction costs of $2.5 million, to the fair value of the assets acquired and liabilities assumed at the date of acquisition (in millions):

Accounts receivable, net	$ 14.0
Total current assets, net of accounts receivable	6.0
Property, plant, and equipment	1.6
Intangible assets	8.7
Goodwill	40.1
Other assets	0.2
Total assets	70.6
Current liabilities	(13.6)
Other liabilities	(1.3)
Net assets acquired	$ 55.7

The goodwill recorded in this transaction is not tax deductible.

On December 31, 2007, the Company acquired Indianapolis, Indiana headquartered Haverstick Consulting, Inc. ("Haverstick") as part of the Kratos Government Solutions segment. Haverstick provides rocket and missile test and evaluation, weapons systems support, and professional services to the U.S. Army, U.S. Air Force, U.S. Navy, NASA, and other federal, state and local agencies. Through the Haverstick acquisition, the Company expanded its customer footprint within the Department of Defense (DoD), and enhanced its presence with the U.S. Air Force, a key growth area for Kratos. The aforementioned factors are the primary reason for the acquisition and the amount subsequently assigned to goodwill.

The total purchase price of $90.2 million includes transaction costs incurred by the Company of $0.5 million. The purchase price paid to Haverstick was $89.7 million comprised of $70.3 million in cash and the issuance of 7.48 million shares of the Company's common stock valued at $2.60 per share, or an aggregate stock consideration of $19.4 million. The value of the shares issued was determined by

KRATOS DEFENSE & SECURITY SOLUTIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Note 7. Acquisitions (Continued)

averaging the market price of the stock two days before and two days after the announcement of the acquisition, which occurred on November 5, 2007. The Company paid $81.1 million, $66.7 million of which was cash paid at closing, $2.4 million was paid shortly thereafter, and $12.0 million in common stock. The Company held back $8.6 million (the Holdback Consideration) to secure any negative working capital adjustments required by the merger agreement and the Company's indemnity rights. The Holdback Consideration is comprised of both cash and Kratos stock in the amounts of $1.2 million and $7.4 million, respectively, and accrues interest at a rate of LIBOR plus 4% until paid. The indemnity rights component of the Holdback Consideration will be released in 50% increments on the 12th month and 21st month of the anniversary date of the acquisition. In addition to the indemnity holdback, the agreement also called for a post closing working capital adjustment. In February 2008, the Company and Haverstick agreed on the working capital calculation called for in the agreement. The calculation resulted in a working capital adjustment due to Haverstick in an amount of $1.5 million. The working capital adjustment was paid with 697,315 shares of Company stock on June 30, 2008, valued at $1.3 million and cash of $0.2 million in April 2008. To fund the acquisition, the Company secured a new credit facility of $85.0 million arranged by KeyBanc Capital Markets. The credit facility, which includes a $25.0 million line of credit and $60.0 million in term notes, replaced the Company's previous credit facility which had an outstanding principal balance of $6.0 million on the date of closing.

Until the date on which the shares of stock became salable, interest accrued on the value of the closing stock at a floating rate of one-month LIBOR plus four percent (4%) per annum. The shares became saleable on June 30, 2008 and 167,692 additional shares were issued in satisfaction of the accrued interest.

The following table summarizes supplemental statement of operations information on an unaudited pro forma basis as if the acquisitions of Haverstick and SYS had occurred on January 1, 2007 and includes adjustments that were directly attributable to the transactions or were not expected to have a continuing impact on the Company, with the exception of approximately $3.2 million of acquisition costs of SYS included in the supplemental statement of operations for the nine months ended September 28, 2008. The pro forma results are for illustrative purposes only for the applicable period and do not purport to be indicative of the actual results which would have occurred had the transaction been completed as of the beginning of the period, nor are they indicative of results of operations which may occur in the future (all unaudited amounts, all, except per share amounts are in millions):

	For the Three Months Ended	For the Nine Months Ended	
	September 30, 2007	September 30, 2007	September 28, 2008
Pro forma revenues	$ 92.0	$ 278.2	$ 258.5
Pro forma net loss	$ (12.2)	$ (28.9)	$ (1.9)
Basic pro forma net loss per share	$ (0.12)	$ (0.28)	$ (0.02)
Diluted pro forma net loss per share	$ (0.12)	$ (0.28)	$ (0.02)

KRATOS DEFENSE & SECURITY SOLUTIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Note 7. Acquisitions (Continued)

Contingent Acquisition Consideration

In connection with certain business acquisitions, the Company may agree to make additional future payments to sellers contingent upon achievement of specific performance-based milestones by the acquired entities. Pursuant to the provisions of SFAS No. 141, such amounts are accrued, and therefore, recorded by the Company when the contingency is resolved beyond a reasonable doubt and the additional consideration becomes payable. The other current liabilities on the accompanying Consolidated Balance Sheet as of September 28, 2008 include $2.4 million for Madison Research Corporation ("MRC") and $0.6 million for Haverstick. Included in other long-term liabilities is $0.6 million for Haverstick with the contingent common stock consideration of $8.2 million reflected as additional paid in capital for contingent consideration in the accompanying Consolidated Financial Statements.

The MRC holdback of approximately $2.4 million was originally due in April 2008 and this date has been extended to provide additional time to resolve outstanding indemnification obligations. The Company expects to make this payment in the fourth quarter of 2008 or early 2009. The remaining amounts for Haverstick of $1.2 million in cash and $8.2 million in common stock are due in equal payments in December 2008 and September 2009. The holdback arrangements accrue interest in accordance with the terms of the purchase agreements.

A summary of the contingent acquisition consideration as of December 31, 2007 and September 28, 2008 is summarized in the following table (in millions):

	Haverstick	MRC	Total
Balance as of December 31, 2007	$ 8.6	$ 2.3	$ 10.9
Post acquisition adjustments and interest accruals	0.8	0.1	0.9
Balance as of September 28, 2008	$ 9.4	$ 2.4	$ 11.8

Note 8. Notes Payable and Other Financing Arrangements

(a)

Credit Agreement

On December 31, 2007, the Company entered into a credit facility of $85.0 million with KeyBanc Capital Markets which replaced the October 2, 2006 credit agreement with Key Bank. This credit facility provides for two term loans consisting of a first lien term note of $50.0 million and a second lien term note of $10.0 million, as well as a first lien $25 million revolving line of credit. The $10.0 million term loan has a five and one half year term with principal payments of $25,000 required quarterly beginning on March 31, 2008 through March 31, 2013 with the final balance of $9.5 million due on June 30, 2013. The $50.0 million term loan has a five year term with principal payments of $0.6 million required quarterly beginning on March 31, 2008 , $1.3 million in 2009, $2.5 million in 2110, and $4.1 million in 2011 and 2012. The term loans have a provision which states that once the full amount of the note has been borrowed, the notes cannot be paid down and reborrowed again. The revolving line of credit has a four year term which expires on December 31, 2011 and contains provisions typical in such arrangements. All loans under the new credit facility have an interest rate equal to a base rate defined as a fluctuating rate per annum equal to the higher of (a) the Federal

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Note 8. Notes Payable and Other Financing Arrangements (Continued)

Funds Rate plus 0.5% and (b) the rate of interest in effect for such day as publicly announced from time to time by KeyBank as its "prime rate" plus a margin for the term loans of 6.5% to 7.5% and a margin of 1.0% to 3.25% on the revolving line of credit. The applicable margin at date of borrowing is determined by the ratio of the Company's aggregate debt to its EBITDA for the previous four fiscal quarters. The Company used the credit facility to fund the acquisition of Haverstick and to retire the outstanding debt from the October 2006 agreement.

The credit agreements contain covenants which impose certain restrictions on the Company's ability to, among other things, incur additional debt, pay dividends, make investments or sell assets. Additionally, certain non-recurring cash inflows such as proceeds from asset sales, insurance recoveries, and equity offerings may have to be used to pay down indebtedness and may not be reborrowed. In addition, the credit agreements contain certain financial covenants which are defined by the terms of the agreements. These financial covenants include a maximum first lien leverage ratio, a maximum total leverage ratio, a minimum liquidity ratio, a minimum fixed charge coverage ratio, and a minimum consolidated EBITDA at various dates for the $50.0 million term loan and the $25.0 million revolver as outlined in the following table.

Date	Maximum First Lien Leverage Ratio	Maximum Total Leverage Ratio	Minimum Liquidity Ratio	Minimum Fixed Charge Coverage Ratio	Minimum Consolidated EBITDA (in millions)
December 31, 2007-2008	3.22 to 4.76:1.00	3.76 to 5.68:1.00	1.56 to 1.33:1.00	1.05 to 0.50:1.00	$16.1 to $19.4
2009	2.97 to 2.33:1.00	2.78 to 3.50:1.00	1.60 to 1.58:1.00	1.11 to 1.02:1.00	$19.8 to $21.5
2010	1.75 to 2.00:1.00	2.25 to 2.50:1.00	1.54 to 1.49:1.00	1.10 to 1.06:1.00	$21.5 to $23.4
2011	1.75:1.00	2.25:1.00	1.55 to 1.53:1.00	1.10:1.00	$24.4 to $26.5
2012	1.75:1.00	2.25:1.00	1.42 to 1.54:1.00	1.10:1.00	$26.7 to $27.6

The $10.0 million subordinated term loan also provides for similar financial covenants.

As of September 28, 2008, the Company's outstanding balance on the facility was $79.5 million and the weighted average interest rate on the debt borrowed during the quarter and nine months ended September 28, 2008 was 11.54% and 11.67% respectively. As of September 28, 2008, the unused line of credit under the revolving line of credit was $2.0 million. The only restriction on the use of these funds is that the Company must be in compliance with covenants of the credit facility. The Company was in compliance with all covenants under the credit facility as of September 28, 2008.

In March 2008, the Company entered into a tentative agreement to settle its 2004 and 2007 securities class action litigation actions and, as a result, the Company recorded a $4.9 million charge in the quarter ended December 31, 2007 to accrue its share of the settlement amounts and an estimate for a contingent liability associated with legal proceedings related to the derivative actions, net of the amounts to be covered by the Company's insurance carriers. As a consequence of recording this legal settlement, the Company did not meet certain of the financial covenants in accordance with the credit facility. Accordingly, on March 27, 2008, the Company obtained an amendment and waiver from its lenders to waive the impact of the legal settlement amounts on its financial covenants as of December 31, 2007 and the affected future periods. The amendment also amended the credit facility to provide for an increase in the LIBOR floor rate to 4.25% and to require that the Company set aside in a restricted account approximately 50% of the proceeds of the recovery from the theft of stock options

KRATOS DEFENSE & SECURITY SOLUTIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Note 8. Notes Payable and Other Financing Arrangements (Continued)

by its former stock option administrator, or approximately $1.7 million, to fund these settlement amounts. In April 2008, $1.7 million was transferred to a restricted cash account and in July 2008, an additional $0.6 million was transferred for the amount received from the insurance carriers as settlement on the theft of stock options. In July 2008, the funding of the 2007 Securities Litigation Settlement included the use of $1.2 million of the cash from the restricted account. The lenders have also reserved the right to require the Company to utilize the entire amount of the $3.4 million in proceeds received from the theft of stock options to permanently pay down indebtedness. This right can be exercised no earlier than 60 days from March 27, 2008 and expires upon the Company's compliance with financial covenants under the credit facility for the four consecutive quarters commencing after January 1, 2008.

On June 26, 2008, the Company entered into a second amendment to its credit facility in order to complete the merger with SYS. The amendment specifically approves that certain unsecured subordinated convertible notes issued by SYS be treated as subordinated debt under the credit facility, provided that a Subordination Agreement is obtained from the note holders representing no less than 95% of the aggregate principal amount of all subordinated notes, which was obtained in July 2008. In addition, the amendment provides for an add-back for amounts representing actual transaction costs incurred by an acquired entity in the computation of Consolidated EBITDA, as defined in the credit agreement, in any acquisition in which 100% of the purchase price is paid in equity securities of the Company.

On February 11, 2008, the Company entered into three derivative financial instruments with Key Bank to reduce the Company's exposure to its variable interest rates on its outstanding debt. These instruments initially hedged $70 million of its LIBOR-based floating rate debt with the amounts hedged decreasing over time. The derivatives mature on March 31, 2010 and March 31, 2011 and result in an average fixed rate of 3.16% for the term of the agreements. The Company designated these instruments as cash flow hedges. In March 2008, as a result of the amendment to the Company's credit facility, which included a LIBOR floor rate of 4.25%, the Company determined that these instruments were no longer highly effective as a hedge. As a result, a charge of $0.7 million from marking the derivative financial instruments to market has been reflected in other income (expense), net rather than in other comprehensive income on the Company's Consolidated Balance Sheet as of March 30, 2008. For the quarter ended June 29, 2008, the result of marking the derivatives to market was a $1.3 million gain reflected in other income (expense), net. For the quarter ended September 28, 2008, the result of marking the derivatives to market was a $0.2 million loss reflected in other income (expense). The net gain associated with the derivatives for the nine months ended September 28, 2008 was $0.4 million. Future gains and losses on these derivative instruments as well as the offsetting gain or loss on the hedged item attributable to the hedged risk will continue to be recognized in the Company's Statement of Operations. See Note 9.

In July 2008, the Company paid $1.8 million related to the 2007 securities litigation settlement. This amount was partially funded with $1.2 million of the funds placed in the Company's restricted cash account with the remaining $0.6 million from the Company's operating cash accounts. The Company expects to pay an additional $2.0 million related to the settlement of the 2004 securities litigation in the fourth quarter of this year. Approximately $1.0 million was paid in October from the restricted cash account and the remaining $2.0 million will come from cash in the Company's operating accounts.

KRATOS DEFENSE & SECURITY SOLUTIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Note 6. Significant Transactions (Continued)

As of September 30, 2008, the Company had outstanding convertible notes payable which were acquired as the result of the SYS acquisition totaling $3.1 million, of which $0.8 million was payable to related parties. The convertible notes payable are unsecured and subordinated to the Company's bank debt and bear interest at 10% per annum payable quarterly. Principal is due February 14, 2009 and the notes are convertible at any time into shares of common stock at a conversion rate of $2.86 per share. The balance of the outstanding notes is reflected in current portion of long-term debt in the accompanying consolidated balance sheets.

Note 9. Fair Value Measurement

The Company adopted SFAS 157 as of January 1, 2008, with the exception of the application of the statement to non-recurring nonfinancial assets and nonfinancial liabilities. Non-recurring nonfinancial assets and nonfinancial liabilities for which it has not applied the provisions of SFAS 157 include those measured at fair value in goodwill impairment testing, indefinite lived intangible assets measured at fair value for impairment testing, asset retirement obligations initially measured at fair value, and those initially measured at fair value in a business combination.

SFAS 157 establishes a valuation hierarchy for disclosure of the inputs to valuation used to measure fair value. This hierarchy prioritizes the inputs into three broad levels as follows. Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities. Level 2 inputs are quoted prices for similar assets and liabilities in active markets or inputs that are observable for the asset or liability, either directly or indirectly through market corroboration, for substantially the full term of the financial instrument. Level 3 inputs are unobservable inputs based on the Company's own assumptions used to measure assets and liabilities at fair value. A financial asset or liability's classification within the hierarchy is determined based on the lowest level input that is significant to the fair value measurement.

The following table provides the assets and liabilities carried at fair value measured on a recurring basis as of September 28, 2008 (in millions):

Fair Value Measurements at September 28, 2008 Using

	Total Carrying Value September 28, 2008	Quoted prices in active markets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
Derivative assets	$ 0.4	$	$ 0.4	$

The significant Level 2 observable inputs utilized to value the Company's derivative financial instruments are based upon calculations provided by an investment advisor and is validated with the use of a nationally recognized financial reporting service.

KRATOS DEFENSE & SECURITY SOLUTIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Note 10. Customer Information

The following table presents the Company's key customers from continuing operations for the periods presented and the percentage of net sales made to such customers (in millions):

	For the Three Months Ended				For the Nine Months Ended			
Key Customers	**September 30, 2007**		**September 28, 2008**		**September 30, 2007**		**September 28, 2008**	
U.S. Navy	$ 9.3	19.6%	$28.5	35.0%	$27.4	19.0%	$74.6	33.6%
U.S. Army	$13.3	28.0%	$10.3	12.6%	$36.3	25.2%	$37.4	16.8%

These key customers are all served by the Kratos Government Solutions segment. The top five customers accounted for approximately 64% and 63% of total revenue for the three and nine months ended September 30, 2007, respectively, and for approximately 58% and 62% of total revenue for the three and nine months ended September 28, 2008.

Note 11. Segment Information

Prior to the divestiture of our wireless-related business, the Company had three operating segments: Wireless Network Services (WNS) segment, Enterprise Network Services (ENS) segment, and Government Network Services (GNS) segment. Following the divestiture of the WNS segment and corporate name change, the Company reorganized into two operating segments, Kratos Government Solutions (KGS) (formerly GNS) and Public Safety and Security (PSS) (formerly ENS). The financial statements in this Quarterly Report are presented in a manner consistent with the new operating structure.

Certain income and charges are not allocated to segments in the Company's management reports because they are not considered in evaluating the segments' operating performance. Unallocated charges are related to corporate expenses previously allocated to the discontinued Wireless Network Services segment, share based compensation charges and related tax adjustments, expenses related to the stock option investigation, a benefit for the insurance proceeds received for the theft of stock options and a benefit related to a change in estimate for the Company's unused office space. These charges are included in corporate activities in the table below. Revenues and operating income

KRATOS DEFENSE & SECURITY SOLUTIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Note 11. Segment Information (Continued)

generated by the Company's current reporting segments for the three and nine months ended September 30, 2007 and September 28, 2008 are as follows (in millions):

	Three months ended		Nine months ended	
	September 30, 2007	September 28, 2008	September 30, 2007	September 28, 2008
Revenues:				
Government Solutions	$ 34.8	$ 68.5	$ 107.4	$ 182.6
Public Safety & Security	12.7	13.0	36.9	39.4
Total revenues	$ 47.5	$ 81.5	$ 144.3	$ 222.0
Operating income (loss):				
Government Solutions	$ 0.7	$ 2.7	$ 3.3	$ 5.3
Public Safety & Security	(1.3)	(0.1)	(5.0)	0.1
Corporate activities	(7.8)	0.4	(18.3)	1.2
Total operating income (loss)	$ (8.4)	$ 3.0	$ (20.0)	$ 6.6

Segment assets as of December 31, 2007 were $292.4 million for the Government Solutions segment and $22.5 million for the Public Safety and Security Segment. Both segments in total will have increased assets due to the acquisition of SYS of approximately $55.7 million. As of September 28, 2008, the allocation of the SYS assets to the segments has not been determined due to a restructuring analysis which is in progress and will be completed in the first half of 2009. This analysis will result in assets being allocated to both the Government Solutions Segment and the Public Safety and Security Segment.

Note 12. Related Party Transactions

In 2002, the Company issued 90,000 shares of Series B Convertible Preferred Stock in a private placement to entities affiliated with one of the directors of the Company (40,000 shares), to a brother of the previous Chairman and Chief Executive Officer of the Company (10,000 shares) and to an unrelated third-party investor (40,000 shares). As of September 28, 2008, a total of 10,000 shares of Series B Convertible Stock remain outstanding with a total liquidation preference of $5.0 million.

The Company acquired unsecured subordinated notes payable as a result of the SYS acquisition and $0.8 million of the notes are held by employees of SYS who are now employees of the Company.

Note 13. Legal Matters

Contingencies

IPO Securities Litigation

Beginning in June 2001, the Company and certain of its officers and directors were named as defendants in several parallel class action shareholder complaints filed in the United States District Court for the Southern District of New York, now consolidated under the caption, In re Wireless Facilities, Inc. Initial Public Offering Securities Litigation, Case No. 01-CV-4779. In the amended

KRATOS DEFENSE & SECURITY SOLUTIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Note 13. Legal Matters (Continued)

complaint, the plaintiffs allege that the Company, certain of its officers and directors, and the underwriters of the Company's initial public offering ("IPO") violated section 11 of the Securities Act of 1933 and section 10(b) of the Securities Exchange Act of 1934 based on allegations that the Company's registration statement and prospectus failed to disclose material facts regarding the compensation to be received by, and the stock allocation practices of, the IPO underwriters. The plaintiffs seek unspecified monetary damages and other relief. Similar complaints were filed in the same court against hundreds of other public companies ("Issuers") that conducted IPOs of their common stock in the late 1990s and 2000 (the "IPO Cases").

In June 2004, the Issuers (including the Company) executed a settlement agreement with the plaintiffs that would, among other things, result in the dismissal with prejudice of all claims against the Issuers and their officers and directors and the assignment of certain potential Issuer claims to the plaintiffs. On February 15, 2005, the court issued a decision certifying a class action for settlement purposes and granting preliminary approval of the settlement subject to modification of certain bar orders contemplated by the settlement. On August 31, 2005, the court reaffirmed class certification and preliminary approval of the modified settlement in a comprehensive Order. On February 24, 2006, the court dismissed litigation filed against certain underwriters in connection with certain claims to be assigned under the settlement. On April 24, 2006, the court held a Final Fairness Hearing to determine whether to grant final approval of the settlement. On December 5, 2006, the Second Circuit Court of Appeals vacated the lower court's earlier decision certifying as class actions the six IPO Cases designated as "focus cases." Thereafter, the District Court ordered a stay of all proceedings in all of the IPO Cases pending the outcome of plaintiffs' petition to the Second Circuit for rehearing en banc and resolution of the class certification issue. On April 6, 2007, the Second Circuit denied plaintiffs' rehearing petition, but clarified that the plaintiffs may seek to certify a more limited class in the District Court. Accordingly, the settlement was terminated pursuant to stipulation and will not receive final approval.

Plaintiffs filed amended complaints in the six focus cases in August 2007. The Company is not one of the focus case issuers. In September 2007, the Company's named officers and directors again extended the tolling agreement with plaintiffs. In September 2007, plaintiffs moved to certify the classes alleged in the focus cases and to appoint class representatives and class counsel in those cases. The focus case issuers filed motions to dismiss the claims against them in November 2007 and an opposition to plaintiffs' motion for class certification in December 2007. The Court denied the motions to dismiss on March 16, 2008. On October 2, 2008, the plaintiffs withdrew their class certification motion. Due to the inherent uncertainties of litigation, the ultimate outcome of this matter cannot be predicted. In accordance with FASB No. 5, "Accounting for Contingencies," the Company believes any contingent liability related to this claim is not probable or estimable and therefore no amounts have been accrued in regards to this matter.

2004 Securities Litigation

In August 2004, following the Company's announcement on August 4, 2004 that it intended to restate its financial statements for the fiscal years ended December 31, 2000, 2001, 2002 and 2003, the Company and certain of its current and former officers and directors were named as defendants ("Defendants") in several securities class action lawsuits filed in the United States District Court for

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Note 13. Legal Matters (Continued)

the Southern District of California. These actions were filed on behalf of those who purchased, or otherwise acquired, the Company's common stock between April 26, 2000 and August 4, 2004. The lawsuits generally allege that, during that time period, Defendants made false and misleading statements to the investing public about the Company's business and financial results, causing its stock to trade at artificially inflated levels. Based on these allegations, the lawsuits allege that Defendants violated the Securities Exchange Act of 1934, and the plaintiffs seek unspecified damages. These actions have been consolidated into a single action In re Wireless Facilities, Inc. Securities Litigation, Master File No. 04CV1589-JAH. Plaintiffs filed a First Amended Consolidated Class Action Complaint on April 1, 2005. Defendants filed their motion to dismiss this first amended complaint on April 14, 2005. The plaintiffs then requested leave to amend their first amended complaint. The plaintiffs filed their Second Amended Complaint on June 9, 2005, this time on behalf of those who purchased, or otherwise acquired, the Company's common stock between May 5, 2003 and August 4, 2004. Defendants filed their motion to dismiss this Second Amended Complaint on July 14, 2005. The motion to dismiss was taken under submission on October 20, 2005 and on March 8, 2006, the Court granted the Defendants' motion. However, plaintiffs were granted the right to amend their complaint within 45 days and subsequently filed their Third Amended Consolidated Class Action Complaint on April 24, 2006. Defendants filed a motion to dismiss this complaint on June 8, 2006. On May 7, 2007, the Court denied the Defendants' motion to dismiss. Defendants' filed their answer to the plaintiffs' complaint on July 13, 2007. In February 2008, following a voluntary mediation of the matter, the parties reached a tentative agreement to settle the class action. Under the tentative settlement, plaintiffs and the class will dismiss all claims, with prejudice, in exchange for a cash payment in the total amount of $12 million. The Company's directors' and officers' liability insurers will pay the settlement amount in accordance with the Company's insurance policies, less any applicable retention or co-insurance obligations that are expected to be paid directly by the Company. The Company estimates that the amount of its payment toward the settlement will be approximately $2.4 million. The Company has accrued approximately $2.4 million as of September 28, 2008 related to this matter and paid $1.0 million in October 2008 from its restricted cash account. The Company expects to fund the remaining $2.0 million towards the settlement in the fourth quarter of 2008 and expects to receive $0.6 million from the insurance carriers for this payment in the first half of 2009.

In June 2008, the parties executed a Memorandum of Understanding documenting the essential terms of the proposed settlement and on August 8, 2008, the parties filed their joint motions for preliminary approval of the proposed settlement with the Court. The Company makes no assurances at this time that the Court will grant final approval of the proposed settlement terms or that the matter ultimately will be settled. Despite the pending settlement reached in this action, the Company believes that the allegations lack merit.

In 2004, two derivative lawsuits were filed in the United States District Court for the Southern District of California against certain of the Company's current and former officers and directors: Pedicini v. Wireless Facilities, Inc., Case No. 04CV1663; and Roth v. Wireless Facilities, Inc., Case No. 04CV1810. These actions were consolidated into a single action in In re Wireless Facilities, Inc. Derivative Litigation, Lead Case No 04CV1663-JAH. These lawsuits contain factual allegations that are substantially similar to those made in the class action lawsuits, but the plaintiffs in these lawsuits assert claims for breach of fiduciary duty, gross mismanagement, abuse of control, waste of corporate assets, violation of Sarbanes Oxley Act section 304, unjust enrichment and insider trading. The plaintiffs in

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Note 13. Legal Matters (Continued)

these lawsuits seek unspecified damages and equitable and/or injunctive relief. The lead plaintiff filed a consolidated complaint on March 21, 2005. On May 3, 2005, the defendants filed motions to dismiss this action, to stay this action pending the resolution of the consolidated non-derivative securities case pending in the Southern District of California, and to dismiss the complaint against certain non-California resident defendants. Pursuant to a request by the Court, Defendants' motions were withdrawn without prejudice pending a decision on defendants' motion to dismiss the complaint against the non-California resident defendants. On March 20, 2007, the Court ruled that it lacked personal jurisdiction over five of the six non-California defendants and dismissed them from the federal derivative complaint. On March 27, 2007, plaintiffs filed an amended derivative complaint setting forth all of the same allegations from the original complaint and adding allegations regarding the Company's stock option granting practices. Basically, plaintiffs allege that the Company "backdated" or "springloaded" employee stock option grants so that the options were granted at less than fair market value. The amended complaint names all of the original defendants (including those dismissed for lack of jurisdiction) as well as nine new defendants. On July 2, 2007, the non-California resident defendants moved to dismiss the complaint for lack of personal jurisdiction. On October 17, 2007, the Court took the motion under submission without oral argument. On February 26, 2008, the Court again ruled that it lacked personal jurisdiction over five of the six non-California defendants and dismissed them from the amended federal derivative complaint. Plaintiffs subsequently moved the Court for certification and entry of final judgment of the Court's order dismissing the non-residents for lack of personal jurisdiction so that the plaintiffs may seek immediate appellate review of the matter. On July 10, 2008, the court granted plaintiffs' motion for certification, which was not opposed by defendants. On August 12, 2008, Plaintiffs filed a notice of appeal of the personal jurisdictional order. Plaintiff's opening brief on the matter is due on or before December 2, 2008, and Defendant's response is due January 2, 2009. A hearing date on the matter has not been set. The parties have conferred and discussed the Court's personal jurisdictional order and notice of appeal and have stipulated to a briefing schedule for any remaining motions to dismiss that the Company, along with the individual defendants subject to the court's jurisdiction, may bring in an effort to dismiss the complaint as to them. Pursuant to the parties' stipulation, such motions must be brought on or before December 5, 2008. The Company believes that the allegations lack merit and intends to vigorously defend all claims asserted. It is impossible at this time to assess whether or not the outcome of these proceedings will have a material adverse effect on the Company.

In April 2007, another derivative complaint was filed in the United States District Court for the Southern District of California, Hameed v. Tayebi, Case No. 07-CV-0680 BTM(RBB) (the "Hameed Action"), against several of the Company's current and former officers and directors. The allegations in this derivative complaint mirrored the amended allegations in the 2004 federal derivative action. Pursuant to a Court order and agreement of the parties, the defendants' responses to the complaint in the Hameed Action were stayed until the Court ruled on the motion to dismiss for lack of personal jurisdiction in the 2004 derivative litigation. As noted above, on February 26, 2008, the Court ruled that it lacked personal jurisdiction over five of the non-California defendants named in the 2004 derivative action, including three that were also named in the Hameed Action. In August 2008, and before defendants had responded to the complaint, Plaintiff voluntarily dismissed the Hameed Action pursuant to Federal Rule of Civil Procedure 41(a). The Company believes that the allegations lacked merit and inten