KRATOS DEFENSE & SECURITY SOLUTIONS, INC.
Form 10-Q
August 06, 2009

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the Quarterly Period Ended June 28, 2009

o **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES AND 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 has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (Section 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). o Yes o No

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

Large accelerated filer	Accelerated filer	Non-accelerated filer	Smaller reporting company
o	ý	o	o

(Do not check if a smaller reporting company)

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

As of August 4, 2009 130,262,381 shares of the registrant's common stock were outstanding.

KRATOS DEFENSE & SECURITY SOLUTIONS, INC.

FORM 10-Q

FOR THE QUARTERLY PERIOD ENDED JUNE 28, 2009

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

KRATOS DEFENSE & SECURITY SOLUTIONS, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

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

	December 28, 2008	June 28, 2009
Assets		
Current assets:		
Cash and cash equivalents	$ 3.7	$ 4.0
Restricted cash	0.4	0.4
Accounts receivable, net	96.4	89.5
Income taxes receivable	0.7	0.8
Prepaid expenses	3.5	2.5
Other current assets	11.5	4.5
Total current assets	116.2	101.7
Property and equipment, net	6.4	5.3
Goodwill	152.2	110.2
Other intangibles, net	32.2	29.3
Other assets	5.4	3.3
Total assets	$ 312.4	$ 249.8
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	$ 17.6	$ 19.2
Accrued expenses	13.2	9.4
Accrued compensation	14.3	13.9
Billings in excess of costs and earnings on uncompleted contracts	9.3	8.2
Current portion of long-term debt	5.9	5.1
Other current liabilities	20.9	14.2
Total current liabilities	81.2	70.0
Long-term debt, net of current portion	76.0	71.1
Other long-term liabilities	8.3	5.8
Total liabilities	165.5	146.9
Commitments and contingencies		
Stockholders' equity:		
Preferred stock, 5,000,000 shares authorized Series B Convertible Preferred Stock, $.001 par value, 10,000 shares outstanding at December 28, 2008 and June 28, 2009 (liquidation preference $5.0 million at June 28, 2009)		
Common stock, $.001 par value, 195,000,000 shares authorized; 128,169,634 and 129,882,339 shares issued and outstanding at December 28, 2008 and June 28, 2009, respectively		
Additional paid-in capital	503.5	504.1
Accumulated deficit	(356.6)	(401.2)

Total stockholders' equity		146.9	102.9
Total liabilities and stockholders' equity	$	312.4	$ 249.8

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

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KRATOS DEFENSE & SECURITY SOLUTIONS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(in millions, except per share amounts)
(Unaudited)

	Three months ended		Six months ended	
	June 29, 2008	June 28, 2009	June 29, 2008	June 28, 2009
Revenues	$ 69.5	$ 90.6	$ 135.0	$ 173.2
Cost of revenues	57.0	73.2	110.3	138.6
Gross profit	12.5	17.4	24.7	34.6
Selling, general and administrative expenses	10.5	13.1	21.7	26.7
Recovery of unauthorized issuance of stock options and adjustment to the liability for unused office space	(1.2)		(1.2)	0.6
Research and development expenses		0.5		0.9
Impairment of goodwill				41.3
Operating income (loss) from continuing operations	3.2	3.8	4.2	(34.9)
Other income (expense):				
Interest expense, net	(2.5)	(3.0)	(4.8)	(5.5)
Other income (expense), net	1.3	(0.2)	0.9	(0.2)
Total other expense, net	(1.2)	(3.2)	(3.9)	(5.7)
Income (loss) from continuing operations before income taxes	2.0	0.6	0.3	(40.6)
Provision for income taxes from continuing operations	0.4	0.3	0.9	0.6
Income (loss) from continuing operations	1.6	0.3	(0.6)	(41.2)
Loss from discontinued operations	(0.8)	(2.8)	(0.5)	(3.4)
Net income (loss)	$ 0.8	$ (2.5)	$ (1.1)	$ (44.6)
Basic income (loss) per common share:				
Income (loss) from continuing operations	$ 0.02	$ 0.00	$ (0.01)	$ (0.32)
Loss from discontinued operations	(0.01)	(0.02)	(0.01)	(0.03)
Net income (loss) per common share:	$ 0.01	$ (0.02)	$ (0.01)	$ (0.35)
Diluted income (loss) per common share:				
Income (loss) from continuing operations	$ 0.02	$ 0.00	$ (0.01)	$ (0.32)
Loss from discontinued operations	(0.01)	(0.02)	(0.01)	(0.03)
Net income (loss) per common share:	$ 0.01	$ (0.02)	$ (0.01)	$ (0.35)
Weighted average common shares outstanding:				
Basic	80.9	130.9	79.5	129.1
Diluted	83.8	133.6	79.5	129.1

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

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KRATOS DEFENSE & SECURITY SOLUTIONS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(in millions)
(Unaudited)

	Six months ended June 29, 2008	Six months ended June 28, 2009
Operating activities:		
Net loss	$ (1.1)	$ (44.6)
Less: Loss from discontinued operations	(0.5)	(3.4)
Loss from continuing operations	(0.6)	(41.2)
Adjustments to reconcile loss from continuing operations to net cash provided by operating activities from continuing operations:		
Depreciation and amortization	3.3	4.3
Deferred income taxes	0.4	
Goodwill impairment charges		41.3
Stock-based compensation	0.4	0.7
Mark to market on swaps	(0.6)	0.2
Change in accrual for unused office space	(0.6)	0.6
Changes in assets and liabilities, net of acquisitions:		
Accounts receivable	0.8	6.9
Prepaid expenses and other assets	4.1	6.2
Accounts payable	3.2	2.1
Accrued compensation	(1.3)	(0.4)
Accrued expenses	(3.0)	(3.5)
Billings in excess of costs and earnings on uncompleted contracts	(2.5)	(1.1)
Income tax receivable and payable	1.4	0.5
Other liabilities	(0.7)	(3.3)
Net cash provided by operating activities from continuing operations	4.3	13.3
Investing activities:		
Cash paid for contingent acquisition consideration		(3.0)
Cash paid for acquisitions, net of cash acquired	1.0	(1.0)
Proceeds/(payments) from the disposition of discontinued operations	2.3	(1.1)
Other	(2.2)	(0.2)
Net cash provided by (used in) investing activities from continuing operations	1.1	(5.3)
Financing activities:		
Borrowings under credit facility	5.0	2.0
Repayment under credit facility	(0.7)	(5.6)
Payments of subordinated debt		(2.1)
Other	(0.1)	0.1
Net cash provided by (used in) financing activities from continuing operations	4.2	(5.6)

Net cash flows of continuing operations		9.6		2.4
Net operating cash flows of discontinued operations		(1.0)		(2.1)
Net increase in cash and cash equivalents		8.6		0.3
Cash and cash equivalents at beginning of period		8.9		3.7
Cash and cash equivalents at end of period	$	17.5	$	4.0

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

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KRATOS DEFENSE & SECURITY SOLUTIONS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

Note 1. Summary of Significant Accounting Policies

(a) Basis of Presentation

The information as of June 28, 2009 and for the three and six months ended June 29, 2008 and June 28, 2009 is unaudited. The condensed consolidated balance sheet as of December 28, 2008 was derived from the Company's audited consolidated financial statements at that date. In the opinion of management, these unaudited condensed consolidated financial statements include all adjustments, consisting of normal recurring adjustments necessary for a fair presentation of the Company's financial position, results of operations and cash flows for the interim periods presented. The results have been prepared in accordance with the instructions to Form 10-Q and do not necessarily include all information and footnotes necessary for presentation in accordance with accounting principles generally accepted in the United States of America. These unaudited condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and the related notes included in the Company's audited annual consolidated financial statements for the year ended December 28, 2008, filed on Form 10-K on March 10, 2009, 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.

(b) 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."

(c) Fiscal Year

The Company's fiscal year end is on the last Sunday of the year, with interim fiscal periods ending on the last Sunday of the last month of each calendar quarter. There are 52 calendar weeks in the fiscal years ended December 28, 2008 and December 27, 2009.

(d) Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America (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 and uncertain tax positions, 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.

(e) Revenue Recognition

The Company generates almost all of its revenue from three different types of contractual arrangements: cost-plus-fee contracts, time-and-materials contracts, and fixed-price contracts.

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Revenue on cost-plus-fee contracts is recognized to the extent of allowable costs incurred plus an estimate of the applicable fees earned. The Company considers fixed fees under cost-plus-fee contracts to be earned in proportion to the allowable costs incurred in performance of the contract and recognizes the relevant portion of the expected fee to be awarded by the customer at the time such fee can be reasonably estimated, based on factors such as our prior award experience and communications with the customer regarding performance, including any interim performance evaluations rendered by the customer. Revenue on time-and-material contracts is recognized to the extent of billable rates times hours delivered for services provided, to the extent of material cost for products delivered to customers, and to the extent of expenses incurred on behalf of the customers.

The Company has three basic categories of fixed price contracts: fixed unit price, fixed price-level of effort, and fixed price-completion. Revenue recognition methods on fixed-price contracts will vary depending on the nature of the work and the contract terms. Revenues on fixed-price service contracts are recorded as work is performed in accordance with Staff Accounting Bulletin 104 "*Revenue Recognition*" (SAB 104). SAB 104 generally requires revenue to be deferred until all of the following have occurred: (1) there is a contract in place, (2) delivery has occurred, (3) the price is fixed or determinable, and (4) collectibility is reasonably assured. Revenues on fixed-price contracts that require delivery of specific items may be recorded based on a price per unit as units are delivered. Revenue for fixed price contracts in which the Company is paid a specific amount to provide services for a stated period of time is recognized ratably over the service period.

A portion of the fixed price-completion contracts are within the scope of Statement of Position 81-1 "*Accounting for Performance of Construction-Type and Certain Production-Type Contracts*" (SOP 81-1). For these contracts, revenue is recognized using the percentage-of-completion method 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 material, direct labor, overhead, and allowable general and administrative expenses for government contracts. These cost estimates are reviewed and, if necessary, revised monthly on a contract-by-contract basis. If, as a result of this review, management determines that a loss on a contract is probable, then the full amount of estimated loss is charged to operations in the period it is determined that it is probable a loss will be realized from the full performance of the contract. In certain instances in which it is impractical to estimate the final outcome of the project margin, but it is certain that the Company will not incur a loss on the project, the Company may record revenue equal to cost incurred, at zero margin. In the event that the cost incurred to date may be in excess of the funded contract value, the Company may defer those costs until the associated contract value has been funded by the customer. Once the final estimate of the outcome of the project margin is determined, the Company will record revenue using the percentage-of-completion method of accounting based on the ratio of total costs incurred to date compared to the estimated total costs to complete the project.

Significant management judgments and estimates, including but not limited to the estimated costs to complete projects, must be made and used in connection with the revenue recognized in any accounting period. A cancellation, schedule delay, or modification of a fixed-price contract which is accounted for using the percentage-of-completion method may adversely affect our gross margins for the period in which the contract is modified or cancelled. Under certain circumstances, a cancellation or negative modification could result in the Company having to reverse revenue that was recognized in a prior period, thus significantly reducing the amount of revenues recognized for the period in which the adjustment is made. Correspondingly, a positive modification may positively affect gross margins. In addition, a schedule delay or modifications can result in an increase in estimated cost to complete the project, which would also result in an impact to gross margins. Material differences may result in the amount and timing of our revenue for any period if management made different judgments or utilized different estimates.

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It is the Company's policy to review any arrangement containing software or software deliverables and services against the criteria contained in Statement of Position 97-2 (SOP 97-2), "*Software Revenue Recognition*", and related technical practice aids. Under the provisions of SOP 97-2, the Company reviews the contract value of software deliverables and services and determines allocations of the contract value based on Vendor Specific Objective Evidence ("VSOE") or fair value for each of the elements. All software arrangements requiring significant production, modification, or customization of the software are accounted for in conformity with Accounting Research Bulletin 45 "*Long-Term Construction-Type Contracts*" (ARB 45), using the relevant guidance in SOP 81-1.

The Company's contracts may include the provision of more than one of its services. In these situations, the Company applies the guidance of FASB's Emerging Issues Task Force (EITF) Issue 00-21, "*Revenue Arrangements with Multiple Deliverables*". Accordingly, for applicable arrangements, revenue recognition includes the proper identification of separate units of accounting and the allocation of revenue across all elements based on relative fair values, with proper consideration given to the guidance provided by other authoritative literature.

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*," 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; and

(5) Whether the Company assumes the credit risk for the amount billed to the customer subsequent to delivery.

For federal contracts, the Company follows U.S. government procurement and accounting standards in assessing the allowability and the allocability of costs to contracts. Due to the significance of the judgments and estimation processes, it is likely that materially different amounts could be recorded if different assumptions were used or if the underlying circumstances were to change. The Company closely monitors compliance with, and the consistent application of, its critical accounting policies related to contract accounting. Business operations personnel conduct periodic contract status and performance reviews. When adjustments in estimated contract revenues or costs are required, any significant changes from prior estimates are included in earnings in the current period. Also, regular and recurring evaluations of contract cost, scheduling and technical matters are performed by management personnel who are independent from the business operations personnel performing work under the contract. Costs incurred and allocated to contracts with the U.S. government are scrutinized for compliance with regulatory standards by the Company's personnel, and are subject to audit by the Defense Contract Audit Agency (DCAA).

From time to time, the Company may proceed with work based on client direction prior to the completion and signing of formal contract documents. The Company has a formal review process for

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approving any such work. Revenue associated with such work is recognized only when it can be reliably estimated and realization is probable. The Company bases its estimates on previous experiences with the client, communications with the client regarding funding status, and its knowledge of available funding for the contract or program. As of December 28, 2008 and June 28, 2009, approximately $0.8 million and $3.5 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.

(f) Cash and Cash Equivalents

The Company has restricted cash accounts of approximately $0.4 million as of December 28, 2008, and June 28, 2009, which are required to collateralize a credit card program and a deposit relating to the run out of a now terminated workers compensation program.

(g) Inventory

Inventories which 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 28, 2008 and June 28, 2009, the Company had $1.7 million and $1.8 million of inventories which were reflected in other current assets on the condensed consolidated balance sheets.

(h) Liquidity

The Company currently carries a significant amount of debt and has historically experienced recurring losses and negative cash flows from continuing operations. Given the Company's highly leveraged liquidity position, any down-turn in its operating earnings or cash flows could impair its ability to comply with the financial covenants of its existing credit facility. Its ability to execute on additional business opportunities may be limited due to its existing borrowing capacity. If the Company believed a covenant violation is more than likely to occur in the near future, it would seek relief from its lenders. This relief, if available, 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.

On June 4, 2009, the Company filed a complaint in the United States District Court for the Northern District of Ohio against the lenders under its Credit Agreement, Field Point III, Ltd. and SPF CDO I, Ltd., both affiliates of Silverpoint Capital LP, and KeyBank National Association seeking equitable relief in the form of reformation of an error in a contract schedule, declaratory relief and damages. The error arises out of the loan agreements, which contain one schedule of the financial covenants, that was erroneously prepared. The Company is specifically seeking reformation of the error in the Minimum Liquidity Ratio Covenant. The Company believes that the facts and the law support its claims.

KeyBank has agreed to reform the error; however any reformation requires Silverpoint's consent which has not been provided. To date, the Company has complied with this covenant and as of June 28, 2009, the Company is in compliance with all financial covenants. However, as the magnitude of the

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error in the schedule increases in future periods, the Company believes that it will become more challenging to continue to manage its working capital around the error in the Minimum Liquidity Ratio covenant if the error is not corrected or the Company does not take alternative actions. In the event that this occurs, the Company intends to seek relief from the court.

(i) Recent Accounting Pronouncements

Adoption of New Accounting Standards

The disclosure requirements of SFAS No. 157 *Fair Value Measurements*, which took effect on January 1, 2008, are presented in Note 9. On January 1, 2009, the Company implemented the previously deferred provisions of SFAS No. 157 for nonfinancial assets and liabilities recorded at fair value, as required.

The disclosure requirements of SFAS No. 161 *Disclosures about Derivative Instruments and Hedging Activities*, which took effect on January 1, 2009, are presented in Note 10.

The accounting requirements of SFAS No. 141(R) *Business Combinations*, which took effect on January 1, 2009, were adopted but had no impact on the Company's consolidated financial statements.

The accounting and presentation requirements of SFAS No. 160 *Noncontrolling Interests in Consolidated Financial Statements an amendment of Accounting Research Bulletin No. 51*, which took effect on January 1, 2009, had no impact on the financial statements as the Company's non-controlling interests were not material.

The disclosure requirements of SFAS No. 165 *Subsequent Events*, which took effect on June 15, 2009, requiring disclosure of the date through which subsequent events have been evaluated. The Company has adopted SFAS No. 165 and considers its' financial statements issued as of the date of filing with the Securities and Exchange Commission (SEC) and as such, evaluates subsequent events up to and including the date of filing with the SEC.

As of June 28, 2009, the Company implemented FASB Staff Position FAS 107-1 and APB 28-1, "Interim Disclosures about Fair Value of Financial Instruments," (FSP FAS 107-1 and APB 28-1). FSP FAS 107-1 and APB 28-1, amends FASB Statement No. 107, Disclosures about Fair Value of Financial Instruments, to require disclosures about fair value of financial instruments in interim as well as in annual financial statements. This FSP also amends APB Opinion No. 28, Interim Financial Reporting, to require those disclosures in all interim financial statements. The FSP is effective for periods ending after June 15, 2009. In the second quarter of 2009, the Company implemented FSP FAS 107-1 and APB 28-1. See Note 9, "Fair Value Measurements."

Standards Issued But Not Yet Effective

Other new pronouncements issued but not effective until after June 28, 2009, are not expected to have a significant effect on the company's consolidated financial position or results of operations.

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Note 2. Goodwill and Other Intangible Assets

Goodwill

The Company performs its annual impairment test for goodwill in accordance with SFAS 142, *Goodwill and Other Intangible Assets* as of the last day of the fiscal year or when evidence of potential impairment exists.

The Company assesses goodwill for impairment at the reporting unit level, which is defined as an operating segment or one level below an operating segment, referred to as a component. The Company determines its reporting units by first identifying its operating segments, and then assessing whether any components of these segments constitute a business for which discrete financial information is available and where segment management regularly reviews the operating results of that component. The Company aggregates components within an operating segment that have similar economic characteristics. For the December 28, 2008 annual impairment assessment and the interim test as of February 28, 2009, the Company identified its reporting units to be its operating segments which are Government Solutions and Public Safety and Security.

The Company's testing approach utilizes a discounted cash flow analysis corroborated by comparative market multiples to determine the fair value of its businesses for comparison to their corresponding book values because there are no observable inputs available (Level 3 hierarchy as defined by SFAS 157, *Fair Value Measurements*). The Company also considers its market capitalization based upon an average of the stock price prior to and subsequent to the date the analysis is performed and reconciles the fair value of the Company's reporting units to the Company's market capitalization assuming a control premium. If the book value exceeds the estimated fair value for a business, a potential impairment is indicated and SFAS 142 prescribes the approach for determining the impairment amount, if any.

Given the continued significant decline in the stock market in general and specifically the Company's stock price and market capitalization in 2009 which declined 39% from an average stock price of $1.29 as of December 28, 2008 to $0.78 as of February 28, 2009, the Company performed an impairment test for goodwill in accordance with SFAS 142 as of February 28, 2009. The test indicated that the book value for the Kratos Government Solutions (KGS) segment exceeded the fair values of these businesses and resulted in the Company recording a charge totaling $41.3 million in its KGS segment in the first quarter of 2009, for the impairment of goodwill. The impairment charge was primarily driven by adverse equity market conditions that caused a decrease in current market multiples and the Company's average stock price as of February 28, 2009, compared with the test performed as of December 28, 2008. The Company's forecasts of growth rates and operating margins had not changed as of February 28, 2009 as compared to the forecasts which were used as of December 28, 2008. The Company reconciles the fair value of its reporting units which is calculated using the income approach to the Company's market capitalization. As a result of this reconciliation, it was noted that investors were requiring a higher rate of return, and therefore, the discount factor which is based upon an estimated market participant weighted average cost of capital (WACC) increased 300 basis points from 14% in the Company's year end impairment test in 2008 as compared to 17% in the Company's 2009 first quarter interim impairment test. This change was the key factor contributing to the $41.3 million goodwill impairment charge that was recorded in the first quarter of 2009.

The Company will continue to evaluate whether a triggering event under SFAS 142 that could be an indication of additional goodwill impairment occurs. If such a triggering event is identified, the Company will perform additional goodwill impairment tests.

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The following tables summarize the changes in the carrying amounts of goodwill and other finite-life intangible assets for the six months ended June 28, 2009 (in millions):

	Government Solutions
Goodwill	
Balance as of December 28, 2008	$ 152.2
Impairments	(41.3)
Purchase accounting adjustments	(0.7)
Balance as of June 28, 2009	$ 110.2

Purchased Intangible Assets

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

	As of December 28, 2008			As of June 28, 2009		
	Gross Value	Accumulated Amortization	Net Value	Gross Value	Accumulated Amortization	Net Value
Acquired finite-lived intangible assets						
Customer relationships	$ 22.1	$ (4.2)	$ 17.9	$ 22.1	$ (5.4)	$ 16.7
Contracts and backlog	17.4	(6.9)	10.5	17.4	(8.5)	8.9
Developed technology	3.1	(0.2)	2.9	3.1	(0.3)	2.8
Non-compete agreements	1.3	(1.3)		1.3	(1.3)	
Trade names	1.3	(0.4)	0.9	1.3	(0.4)	0.9
Total	$ 45.2	$ (13.0)	$ 32.2	$ 45.2	$ (15.9)	$ 29.3

Consolidated amortization expense related to intangible assets subject to amortization was $1.1 million and $1.4 million for the quarters ended June 29, 2008 and June 28, 2009, respectively and $2.2 million and $2.9 million for the six months ended June 28, 2008 and June 28, 2009, respectively.

Note 3. Stockholders' Equity

The Company had the following equity incentive plans under which shares were available for grant at June 28, 2009: 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").

Digital Fusion, Inc. 1998, 1999, 2000, and 2005 Stock Option and Stock Incentive Plans.

In connection with the Company's acquisition of Digital Fusion, Inc. (DFI) on December 24, 2008, the Company assumed all outstanding options under DFI's 1998, 1999, 2000, and 2005 Stock Option and Stock Incentive Plans. No further grants will be made under these plans. Award grants that were outstanding under these plans on December 24, 2008 continue to be governed by their terms and may be exercised for shares of the Company's common stock at any time prior to the expiration of the option pursuant to its terms. Stock options granted under these plans included incentive stock options and non-statutory stock options. All non-statutory options vest upon change in control and were 100% vested on December 24, 2008. With respect to incentive stock options, the qualified stock option plans provide that the exercise price of each such option must be at least equal to 100% of the fair market value of its common stock on the date of grant. Stock options granted under these plans may generally be exercised from one to ten years after the date of grant. Certain of these options had change in control provisions that extended the exercise period for grants for two years from the transaction closing date. Awards granted under these plans generally vest equally over three years; however, in

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connection with the Company's acquisition of DFI the plans were amended to include immediate vesting of all unvested grants upon any future change in control of the Company. DFI also granted certain options outside of its qualified stock option plans. These non-qualified "out of plan" stock options have been assumed by the Company and expire 10 years from the grant date.

The Company also has a form of Restricted Stock Unit Agreement (the "RSU Agreement") to govern the issuance of restricted stock units ("RSU") to executive officers under the Company's 2005 Plan.

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

	Restricted Stock Units (000's)	Weighted-Average Grant-Date Fair Value
Nonvested balance, December 28, 2008	2,844	$ 2.21
Grants	1,775	$ 1.40
Vested	(65)	$ 2.06
Cancellations/Forfeitures	(141)	$ 1.56
Nonvested balance June 28, 2009	4,413	$ 1.91

The following table shows the amounts recognized in the financial statements for the three and six month periods ended June 29, 2008 and June 28, 2009 for stock-based compensation expense related to employees (in millions, except per share data). The stock-based compensation expense for the three months and six-months ended June 29, 2008 and June 28, 2009 primarily relates to the grant of restricted stock units. In addition, for the three and six months ended June 29, 2008 and June 28, 2009, there was no incremental tax benefit from stock options exercised in the period.

	For the Three Months Ended		For the Six Months Ended	
	June 29, 2008	June 28, 2009	June 29, 2008	June 28, 2009
Selling, general and administrative	$ 0.2	$ 0.3	$ 0.4	$ 0.7
Total cost of employee share-based compensation included in income (loss) from continuing operations, before income tax	0.2	0.3	0.4	0.7
Amount charged against income (loss) from discontinued operations	0.0	0.0	0.0	0.0
Total charged against operations	$ 0.2	$ 0.3	$ 0.4	$ 0.7
Total impact on net income (loss) per common share:				
Basic	$ (0.00)	$ (0.00)	$ (0.00)	$ (0.01)
Diluted	$ (0.00)	$ (0.00)	$ (0.00)	$ (0.01)

In August 1999, the Board of Directors approved the 1999 Employee Stock Purchase Plan (the "Purchase Plan"). A total of 4.4 million shares of common stock have been authorized for issuance under the Purchase Plan. The Purchase Plan qualifies as an employee stock purchase plan within the meaning of Section 423 of the Internal Revenue Service Code. The Purchase Plan commenced in November 1999 upon completion of the Company's initial public offering. On November 16, 2005, the Compensation Committee of the Board of Directors elected to suspend all future offerings under the Purchase Plan effective January 1, 2006. On February 27, 2008, the Compensation Committee elected to reinstate offerings under the Purchase Plan effective April 1, 2008.

Employees who actively participate in the Purchase Plan are eligible to have up to 15% of their earnings for each purchase period withheld pursuant to the Purchase Plan. The amount that was

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withheld was used at various purchase dates within the offering period to purchase shares of common stock. The price paid for common stock at each such purchase date is equal to the lower of 85% of the fair market value of the common stock at the commencement date of that offering period or 85% of the fair market value of the common stock on the relevant purchase date. Employees are also able to end their participation in the offering at any time during the offering period, and participation ends automatically upon termination of employment. For the six-month period ended June 28, 2009, 0.2 million shares were purchased with a total value of $0.2 million. No shares were purchased under the plan for the six-month period ended June 29, 2008.

On March 31, 2009, the Company issued 1.4 million shares of common stock to the former shareholders of Haverstick Consulting, Inc. in payment of the stock portion of the first holdback consideration pursuant to the Agreement and Plan of Merger, dated November 2, 2007. These shares were issued without registration under the Securities Act of 1933, as amended (the "Securities Act"), in reliance upon the exemption provided by Section 4(2) under the Securities Act and Regulation D there under.

A summary of the changes in Stockholders' Equity for the periods ended June 29, 2008 and June 28, 2009 is provided below (in millions):

	Six Months Ended June 29, 2008	Six Months Ended June 28, 2009
Stockholders' equity at beginning of period	$ 167.2	$ 146.9
Stock-based compensation	0.4	0.7
Working capital adjustment for Haverstick acquisition	1.3	(0.2)
ESPP Plan and RSU settlement in cash		0.1
Additional paid-in-capital for acquisition	51.8	
Net loss	(1.1)	(44.6)
Stockholders' equity at end of period	$ 219.6	$ 102.9

The Company has two classes of stock, Series B Convertible Preferred Stock and common stock. There was no issuance, redemption or conversion of the Series B Convertible Preferred Stock for the six months ended June 29, 2008 and June 28, 2009. Common stock issued by the Company for the six months ended June 29, 2008, and June 28, 2009, was as follows (in millions):

	Six Months Ended June 29, 2008	Six Months Ended June 28, 2009
Shares outstanding at beginning of the period	79.0	128.2
Stock issued for employee stock purchase plan, stock options and RSUs exercised		0.3
Common stock issued for acquisitions	26.0	1.4
Shares outstanding at end of the period	105.0	129.9

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At the Annual Meeting on June 4, 2009, the stockholders of the Company approved an Amendment to the Amended Certificate of Incorporation to effect a reverse stock split of the Company's common stock. The Amendment provides for not less than one new, post reverse split share of common stock for each ten shares of the existing common stock and not more than one new, post reverse split share of common stock for each twenty shares of existing common stock. As of June 28, 2009, the Amendment for the reverse stock split had not been executed. The Company has one year from the date of the approval, June 4, 2009, to execute the reverse stock split. The Company's Board of Directors approved a 1-for-10 reverse split of its common stock on August 5, 2009. The record date established for the reverse stock split is September 10, 2009 and the reverse stock split will be effective at 11:59 p.m., Eastern Time, on September 10, 2009. The reverse split will reduce the number of shares of Kratos' common stock outstanding from approximately 130.3 million to 13.0 million. Proportional adjustments will be made to Kratos' stock options and other equity incentive awards, equity compensation plans, outstanding warrants and convertible notes. The total number of authorized shares of the Company's capital stock will not be affected by the reverse stock split.

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 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).

Components of basic and diluted earnings per share were as follows:

	For the Three Months Ended		For the Six Months Ended	
(In millions, except earnings per share)	**June 29, 2008**	**June 28, 2009**	**June 29, 2008**	**June 28, 2009**
Net income (loss) from continuing operations available for common shareholders (A)	$ 1.6	$ (0.3)	$ (0.6)	$ (41.2)
Weighted average outstanding shares of common stock (B)	80.9	130.9	79.5	129.1
Dilutive effect of employee stock options and awards		1.3		
Dilutive effect of contingently issuable shares	2.9	1.4		
Common stock and common stock equivalents (C)	83.8	133.6	79.5	129.1
Earnings per share:				
Basic (A/B)	$ 0.02	$ 0.00	$ (0.01)	$ (0.32)
Diluted (A/C)	$ 0.02	$ 0.00	$ (0.01)	$ (0.32)

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

	For the Three Months Ended		For the Six Months Ended	
(In millions)	**June 29, 2008**	**June 28, 2009**	**June 29, 2008**	**June 28, 2009**
Shares from stock options and awards	8.9	16.8	8.9	16.7
Shares from preferred stock			1.0	1.0
Shares of contingently issuable common stock			2.9	1.4
Shares of common stock from convertible debt		0.9		0.9

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Note 5. Income Taxes

As of December 28, 2008, the Company had $12.8 million of unrecognized tax benefits. During the first quarter of 2009, this amount was reduced by $0.3 million relating to the expiration of statutes of limitations. The reduction in unrecognized tax benefits was recorded as a tax benefit from discontinued operations for $0.3 million. There were no changes in unrecognized tax benefits during the second quarter of 2009 resulting in unrecognized tax benefits at June 28, 2009 of $12.5 million.

The Company recognizes interest and penalties related to unrecognized tax benefits in its provision for income taxes. The Company recorded $0.1 million during the period ended June 29, 2008. There were no material amounts recorded during the period ended June 28, 2009.

The Company believes that it is reasonably possible that as much as $3.5 million of the FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (FIN 48) tax liabilities will expire within 12 months of June 28, 2009 due to the expiration of various applicable statutes of limitations and possible settlement of a pending income tax refund claim.

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.

A reconciliation of total income tax provision to the amount computed by applying the statutory federal income tax rate of 35% to loss from continuing operations before income tax provision for the three and six months ended June 29, 2008 and June 28, 2009 is as follows (in millions):

	For the Three Months Ended		For the Six Months Ended	
	June 29, 2008	June 28, 2009	June 29, 2008	June 28, 2009
Income tax expense (benefit) at federal statutory rate	$ 0.6	$ 0.5	$ (0.1)	$ (14.2)
State taxes, net of federal tax benefit and valuation allowance	0.3	0.3	0.5	0.6
Nondeductible goodwill impairment charges				14.5
Nondeductible expenses			0.1	0.1
Increase (decrease) in federal valuation allowance	(0.5)	(0.5)	0.4	(0.4)
Total	$ 0.4	$ 0.3	$ 0.9	$ 0.6

Note 6. Acquisitions

Digital Fusion, Inc.

On December 24, 2008, the Company acquired Huntsville, Alabama based Digital Fusion, Inc. (DFI) in a stock for stock transaction for approximately $37.0 million. DFI provides Command, Control, Communications, Computing, Intelligence, Surveillance, and Reconnaissance (C4ISR) and technical engineering services, Unmanned Aerial Vehicle (UAV) products and technology and has significant engineering, modeling and simulation capabilities. The acquisition of DFI provides Kratos with new customers and an expanded contract vehicle portfolio, in addition to expanding the range of service offerings to existing Kratos customers. Principal customers of DFI include the Army Aviation

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and Missile Research, Development and Engineering Center (AMRDEC), Army Space and Missile Defense Command/Army Forces Strategic Command ARSTRAT), NASA Marshall Space Flight Center, and certain classified customers. The aforementioned factors are the primary reason for the acquisition and the amount subsequently assigned to goodwill.

The purchase price of $37.0 million includes direct transaction costs of $0.9 million. The Company issued 22.9 million shares to DFI shareholders and assumed DFI options which are now exercisable for approximately 10.0 million shares of Kratos common stock. 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 22.9 million, based on 12.8 million shares of DFI common stock outstanding and the exchange ratio of 1.7933 for each DFI share, at a price of $1.27 per share, the average closing price of Kratos shares of common stock on the announcement date and for the two days prior to and two days subsequent to the public announcement of the merger on November 24, 2008. The Company assumed DFI options valued at the exchange ratio of 1.7933 for each DFI option. The fair value of the assumed options that was allocated to goodwill based upon the Black-Scholes pricing model was $7.0 million. The fair value of unvested options which are related to future service will be expensed as the service is performed over the weighted average vesting period of 1.2 years. The results of operations of DFI are included in the accompanying condensed consolidated financial statements for the six months ended June 28, 2009.

The following summarizes the allocation of the purchase price, including transaction costs of $0.9 million, to the fair value of the assets acquired and liabilities assumed at the date of acquisition (in millions):

Cash	$ 2.3
Accounts receivable, net	10.0
Other current assets	0.1
Property, plant, and equipment	1.0
Intangible assets	9.3
Goodwill	23.8
Other assets	0.4
Total assets	46.9
Current liabilities	(9.0)
Other liabilities	(0.9)
Net assets acquired	$37.0

The goodwill recorded in this transaction is not tax deductible with the exception of approximately $3.6 million which was tax deductible to DFI.

SYS Technologies

On June 28, 2008, the Company acquired San Diego-based SYS Technologies (SYS). SYS provides a range of C4ISR 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 C4ISR. The amount of goodwill assigned in the allocation of purchase price is primarily attributable to the aforementioned advantages of this acquisition.

The purchase price of $55.9 million includes direct transaction costs of $2.4 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

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20.1 million shares of SYS common stock outstanding and the exchange ratio of 1.2582 for each SYS share, at a price of $2.022 per share, the average closing price of Kratos common stock on the announcement date and for the two days prior to and two days subsequent to the public announcement of the merger on February 21, 2008. Following the closing of the acquisition, the Company implemented a plan to restructure and/or exit certain business activities of SYS. The plan included a comprehensive assessment of personnel, relocation of personnel, facility consolidation and exit strategies for certain lines of business. The plan provided for approximately $2.0 million of restructuring costs associated with personnel, and additional costs of $0.5 million for facilities consolidation. The restructuring costs are primarily associated with the businesses sold and are accounted for in discontinued operations in the accompanying condensed consolidated financial statements. As of June 28, 2009, approximately $1.0 million of the restructuring and facilities consolidation costs have been paid.

In addition, the Company identified three business units of SYS that were not core to its business strategy and/or have been dilutive to profitability. The Company believes the divestiture of these businesses will slightly reduce revenues going forward and increase profitability and cash flow. The sale of these businesses was completed in the quarter ended March 29, 2009 for an aggregate cash consideration of approximately $0.4 million. These businesses have been classified as discontinued operations in the accompanying Condensed Consolidated Financial Statements.

The following summarizes the allocation of the purchase price, including transaction costs of $2.4 million, to the fair value of the assets acquired and liabilities assumed at the date of acquisition (in millions):

Cash	$ 4.0
Accounts receivable, net	13.6
Other current assets	1.7
Property, plant, and equipment	1.4
Intangible assets	8.9
Goodwill	40.1
Other assets	0.2
Total assets	69.9
Current liabilities	(13.2)
Other liabilities	(0.8)
Net assets acquired	$ 55.9

The goodwill recorded in this transaction is not tax deductible with the exception of approximately $6.7 million which was tax deductible to SYS.

Unaudited Pro Forma Financial Information

The following tables summarize the supplemental statement of operations information on an unaudited pro forma basis as if the acquisitions of SYS and DFI had occurred on January 1, 2008, and include adjustments that were directly attributable to the transactions or were not expected to have a continuing impact on the Company. 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

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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 amounts, except per share amounts are in millions):

	Three Months Ended June 29, 2008 As Reported	SYS Pro forma Adjustments	DFI Pro forma Adjustments	Three Months Ended June 29, 2008 Pro forma
Pro forma revenues	$ 69.5	$ 17.6	$ 17.1	$ 104.2
Pro forma net income	$ 0.8	$ 0.4	$ 0.3	$ 1.5
Basic shares outstanding or issued for acquisition	80.9	25.3	22.9	129.1
	83.8	25.3	22.9	132.0
Basic pro forma net loss per share	$ 0.01			$ 0.01
Diluted pro forma net loss per share	$ 0.01			$ 0.01

	Six Months Ended June 29, 2008 As Reported	SYS Pro forma Adjustments	DFI Pro forma Adjustments	Six Months Ended June 29, 2008 Pro forma
Pro forma revenues	$ 135.0	$ 34.9	$ 30.4	$ 200.3
Pro forma net income (loss)	$ (1.1)	$ 2.2	$ 0.2	$ 1.3
Shares outstanding or issued for acquisition	79.5	25.3	22.9	127.7
Basic and diluted pro forma net income (loss) per share	$ (0.01)			$ 0.01

The decline in revenues for the three and six months ended June 28, 2009 as compared to the pro forma amounts for the three and six months ended June 29, 2008, which was expected by the Company, is primarily due to the impact of the conversion of work as a prime contractor under certain legacy small business awards to that of a subcontractor. This change resulted in an award of an overall smaller portion of the entire project as the contracts were recompeted and the original term of the small business contracts were completed. It is not uncommon in defense contracting for a company that has acquired other companies to experience a conversion from prime to subcontractor status in connection with legacy small business contracts.

Contingent Acquisition Consideration

In connection with two prior business acquisitions, Madison Research Corporation (MRC) and Haverstick Consulting, Inc. (Haverstick), the Company has agreed 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 141, *Business Combinations* (SFAS 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 Company resolved all outstanding indemnification obligations related to the MRC holdback and made the final payment of $2.4 million in March 2009. The stock portion of the Haverstick holdback payment of 1.4 million shares and the cash payment of $0.6 million was made in March 2009. The other current liabilities on the accompanying condensed consolidated balance sheet as of June 28, 2009 includes $0.6 million for the final Haverstick cash holdback and the Haverstick common stock holdback consideration of $3.7 million is reflected as additional paid in capital for contingent consideration in the accompanying condensed consolidated financial statements.

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A summary of the contingent acquisition consideration as of December 28, 2008 and June 28, 2009 is summarized in the following table (in millions):

	Haverstick	MRC	Total
Balance as of December 28, 2008	$ 8.9	$ 2.5	$11.4
Principal and interest cash payments	(0.6)	(2.4)	(3.0)
Issuance of stock	(3.7)		(3.7)
Post acquisition adjustments and interest accruals, net	(0.3)	(0.1)	(0.4)
Balance as of June 28, 2009	$ 4.3	$	$ 4.3

Note 7. Discontinued Operations

On July 7, 2007, the Company entered into a definitive agreement with an affiliate of Platinum Equity to sell the Company's wireless deployment business. Platinum Equity is a Los Angeles based private equity firm whose portfolio includes service and distribution businesses in a number of equity sectors. The total consideration for the acquisition was $24.0 million including $18.0 million in cash at closing, subject to post closing working capital adjustments, and an aggregate $6.0 million in a three-year earn-out arrangement through 2010. The transaction included a Transition Services Agreement for the transition of certain services for a period of nine months. The assets sold to an affiliate of Platinum Equity included all of the Company's wireless deployment business, and the Wireless Facilities name. The transaction closed on July 24, 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 was 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, with an additional $0.5 million paid in December 2008. In March of 2009, the Company paid $1.5 million of the working capital adjustment. As of June 28, 2009, the balance of $1.0 million plus accrued interest on the outstanding balance has been reflected in other current liabilities. On August 3, 2009, Platinum Equity agreed to reduce the accrued interest by approximately $0.2 million. On August 4, 2009, the Company paid $1.3 million in full settlement of amounts due to Platinum Equity.

During the due diligence process related to the acquisition of SYS, senior management identified three business units of SYS which were non-core to Kratos' base national security and public security businesses. These businesses provided video surveillance and information analysis products, digital broadcasting products and incident response management systems. In December 2008, after evaluating these businesses further, a decision was made to dispose of and sell all three business units. In accordance with SFAS 144, *Accounting for the Impairment or Disposal of Long-Lived Assets* (SFAS144), these business units were classified as held for sale and reported in discontinued operations as of and for the year ended December 28, 2008, and the six months ended June 28, 2009, respectively. The Company recorded a $4.5 million impairment charge in the fourth quarter of 2008 primarily related to the impairment of goodwill and intangibles allocated to these businesses. In the first quarter of 2009, all three of the businesses were sold for an aggregate cash consideration of approximately $0.4 million.

On June 24, 2009, as a result of the continued operating losses in the Southeast division of the Company's Public Safety and Security segment, the Company's Board of Directors approved a plan to sell and dispose of the Southeast division. In accordance with SFAS 144 this business unit was classified as held for sale and reported in discontinued operations in the accompanying Condensed Consolidated

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Financial Statements. The Company recorded a $2.0 million impairment charge in the second quarter of 2009 related to management's estimate of the fair value of the business.

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

	For the Three Months Ended		For the Six Months Ended	
	June 29, 2008	June 28, 2009	June 29, 2008	June 28, 2009
Revenue	$ 2.9	$ 1.3	$ 5.5	$ 2.6
Net loss before taxes	(0.6)	(2.6)	(1.4)	(3.8)
Provision (benefit) for income taxes	0.2	0.2	(0.9)	(0.4)
Net loss after taxes	$ (0.8)	$ (2.8)	$ (0.5)	$ (3.4)

Following is a summary of the assets and liabilities of discontinued operations which are in other current assets, other assets, other current liabilities and other long-term liabilities in the accompanying condensed consolidated balance sheets as of December 28, 2008 and June 28, 2009 (in millions):

	December 28, 2008	June 28, 2009
Cash	$ (0.4)	$
Accounts receivable, net	4.5	2.3
Other current assets	1.0	0.7
Impairment allowance		(1.2)
Current assets of discontinued operations	$ 5.1	$ 1.8
Non-current assets of discontinued operations	$ 1.0	$ 0.4
Accounts payable	$ 0.9	$ 0.6
Accrued expenses	5.1	3.7
Unrecognized tax benefits	0.8	1.1
Other current liabilities	0.3	0.3
Current liabilities of discontinued operations	$ 7.1	$ 5.7
Non-current unrecognized tax benefits	$ 1.1	$ 0.5
Other non-current liabilities	0.8	0.4
Non-current liabilities of discontinued operations	$ 1.9	$ 0.9

Note 8. Debt

(a) Credit Agreement

The Company has a credit facility of $85.0 million with KeyBank National Association ("KeyBank") as administrative agent. 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 $25.0 million revolving line of credit, and is collateralized by the assets of the Company and its subsidiaries. KeyBank holds the revolving line of credit and the second lien term note. Field Point III, Ltd. and SPF CDO I, Ltd., both affiliates of Silverpoint Capital LP ("Silverpoint"), hold the first lien term note. 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 2010, 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

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reborrowed again. The revolving line of credit has a four year term which expires on December 31, 2011. All loans under the 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 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. All rates are subject to a LIBOR floor of 4.25% and a "prime rate" floor of 5.25%.

As of June 28, 2009, the Company's outstanding balance on the facility was $75.2 million and the weighted average interest rate on the debt borrowed during the quarter and six months ended June 28, 2009 was 10.53%, with $45.0 million on the first lien term loan, $9.8 million on the second lien term loan and $20.4 million on the revolving line of credit. As of June 28, 2009, the unused line of credit under the revolving line of credit, net of $1.4 million in outstanding letters of credit, was approximately $3.2 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 June 28, 2009.

On June 4, 2009, the Company filed a complaint in the United States District Court for the Northern District of Ohio against the lenders under its credit agreement, Field Point III, Ltd. and SPF CDO I, Ltd., both affiliates of Silverpoint, and KeyBank National Association seeking equitable relief in the form of reformation of an error in a contract schedule, declaratory relief and damages. The error resulted from the erroneous preparation of a schedule to the loan documents consisting of calculations relating to a financial covenant. The Company is specifically seeking reformation of the error in the Minimum Liquidity Ratio covenant.

KeyBank has agreed to reform the error, however, any reformation requires Silverpoint's consent which has not been provided. To date, the Company has met this covenant without the requested reformation. However, because the magnitude of the error in the schedule increases in future periods, the Company believes that it will become more challenging to continue to manage around the error in the Minimum Liquidity Ratio covenant unless the error is corrected or the Company takes alternative actions. In the event that this occurs, the Company intends to seek relief from the court.

(b) Subordinated Notes

As of December 28, 2008, the Company had outstanding convertible notes payable totaling $3.1 million which were acquired as a result of the SYS acquisition, 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 was due February 14, 2009 and the notes were convertible at any time into shares of common stock at a conversion rate of $2.86 per share. In February 2009, in the interest of preserving cash due to the current macroeconomic conditions, the Company provided each note holder with the option to:

(1) be paid cash in accordance with the original agreement;

(2) extend the note for an additional 18 months at the existing 10% rate and modify the conversion feature to the lower of the existing conversion price of $2.86 per share or the Kratos closing share value on February 13, 2009; or

(3) convert the principal balance into Kratos shares at the lower of the existing conversion price of $2.86 or the Kratos closing share value on February 13, 2009 less a 10% discount.

As of June 28, 2009, $2.1 million of the notes had been paid and $1.0 million of the notes had been extended to August 14, 2010, $25,000 of which is payable to a related party. The balance of the outstanding notes of $1.0 million, which is potentially convertible into common stock of Kratos at $1.02 per share or approximately 944,000 shares, is reflected in long-term debt in the accompanying condensed consolidated balance sheets.

Interest expense on the convertible notes was approximately $24,000 and $84,000 for the three and six month period ended June 28, 2009.

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Note 9. Fair Value Measurement

SFAS 157, *Fair Value Measurements* (SFAS 157) defines fair value, establishes a market-based framework or hierarchy for measuring fair value, and expands disclosures about fair value measurements. SFAS 157 is applicable whenever another accounting pronouncement requires or permits assets and liabilities to be measured at fair value, but does not require any new fair value measurements.

The fair value hierarchy established in SFAS 157 prioritizes the inputs used in valuation techniques into three levels as follows:

Level 1 Observable inputs quoted prices in active markets for identical assets and liabilities;

Level 2 Observable inputs other than the quoted prices in active markets for identical assets and liabilities includes quoted prices for similar instruments, quoted prices for identical or similar instruments in inactive markets, and amounts derived from valuation models where all significant inputs are observable in active markets; and

Level 3 Unobservable inputs includes amounts derived from valuation models where one or more significant inputs are unobservable and require the Company to develop relevant assumptions.

The following table presents assets and liabilities measured and recorded at fair value on the Company's balance sheet on a recurring basis and their level within the fair value hierarchy as of June 28, 2009:

	Total Carrying Value June 28, 2009	Quoted prices in active markets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
Derivative liabilities (interest rates swaps)	$ 1.9	$	$ 1.9	$

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.

Carrying amounts and the related estimated fair values of the Company's financial instruments not measured at fair value on a recurring basis at December 28, 2008 and June 28, 2009 are presented in the following table. The carrying value of all other financial instruments, including cash and cash equivalents and short-term debt, approximated their estimated fair values at December 28, 2008 and June 28, 2009.

	December 28, 2008		June 28, 2009	
$ in millions	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Long-term debt	$ 76.0	$ 73.4	$ 71.1	$ 68.6

Long-Term Debt The fair value of the long-term debt was calculated based on interest rates available for debt with terms and due dates similar to the Company's existing debt arrangements.

Note 10. Derivatives

In the first quarter of 2009, the Company adopted SFAS 161, *Disclosures about Derivative Instruments and Hedging Activities an amendment of FASB Statement No. 133* (SFAS 161), which requires enhanced qualitative disclosures about the Company's objectives and strategies for using derivatives and quantitative disclosures about the fair value amounts of gains and losses on derivative instruments.

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The Company uses derivative financial instruments, in particular, interest rate swaps, to reduce the Company's exposure to its variable rate debt. The primary objective of the interest rate swaps is to eliminate the variability of cash flows and interest rate risk for payments made on variable rate debt, the sole source of which is due to changes in the benchmark three month LIBOR interest rate. Changes in the cash flows of the interest rate swap are expected to exactly offset the changes in cash flows (i.e., changes in interest rate payments) attributable to fluctuations in the three month LIBOR on the variable-rate debt.

The Company records derivatives at their fair value. The classification of gains and losses resulting from changes in the fair values of derivatives is dependent on the Company's intended use of the derivative and its resulting designation. Adjustments to reflect changes in fair values of derivatives that the Company consider highly effective hedges are either reflected in earnings and largely offset by corresponding adjustments to the hedged items, or reflected net of income taxes in accumulated other comprehensive income (loss) until the hedged transaction is recognized in earnings, to the extent these derivatives are effective hedges. Changes in the fair value of these derivatives that are attributable to the ineffective portion of the hedges, or of derivatives that are not considered to be highly effective hedges, if any, are immediately recognized in earnings. The aggregate notional amount of outstanding interest rate swap contracts at June 28, 2009 was $65.0 million.

The Company's derivative financial instruments, which are cash flow hedges, were considered ineffective as a result of the interest rate floor that occurred with the first amendment of the Company's credit facility in March 2008. The effect of marking the derivative instruments to market for the three and six months ended June 29, 2008 was income of $1.3 million and $0.6 million, respectively, and for the three and six months ended June 28, 2009 was an expense of $0.2 million; all of which is reflected in other income/expense in the accompanying condensed consolidated statements of operations. The fair value of the Company's derivative liabilities as of December 28, 2008 and June 28, 2009 was $1.7 million and $1.9 million, respectively, and is carried in other long-term liabilities in the accompanying condensed consolidated balance sheets. See Note 9 for further discussion on the fair value measurements related to the Company's derivative instruments.

Note 11. Significant Customers

The following table presents our key customers for the periods presented and the percentage of net sales made to such customers (in millions):

	For the Three Months Ended				For the Six Months Ended			
Key Customers	**June 29, 2008**		**June 28, 2009**		**June 29, 2008**		**June 28, 2009**	
U.S. Navy	$24.1	34.7%	$31.0	34.2%	$46.1	34.1%	$57.0	32.9%
U.S. Army	$14.5	20.9%	$18.3	20.2%	$27.0	20.0%	$36.7	21.2%

The customers are all part of the Kratos Government Services segment. The Company's top five customers accounted for approximately 68% and 67% of total revenue for the three and six months ended June 29, 2008 and for approximately 65% and 64% for the three and six months ended June 28, 2009, respectively. Total revenue from the federal government for the three and six months ended June 29, 2008 was $54.3 million and $105.2 million, respectively, and for the three and six months ended June 28, 2009 was $78.4 million and $149.8 million, respectively.

Note 12. Segment Information

The Company operates in two principal business segments: Kratos Government Solutions (KGS) and Public Safety and Security (PSS). The Company organizes its business segments based on the nature of the services offered. In the following table, total operating income of the business segments is reconciled to the corresponding consolidated amount. The reconciling item "Unallocated Corporate

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income (expense), net" includes costs for certain stock-based compensation programs (including stock-based compensation costs for stock options and restricted stock units), the effects of items not considered part of management's evaluation of segment operating performance, corporate costs not allocated to the operating segments, and other miscellaneous corporate activities. Transactions between segments are generally negotiated and accounted for under terms and conditions similar to other government and commercial contracts.

Revenues and operating income generated by the Company's current reporting segments for the three and six months ended June 29, 2008 and June 28, 2009 are as follows (in millions):

	Three months ended		Six months ended	
	June 29, 2008	June 28, 2009	June 29, 2008	June 28, 2009
Revenues:				
Government Solutions	$ 59.2	$ 83.2	$ 114.1	$ 157.6
Public Safety & Security	10.3	7.4	20.9	15.6
Total revenues	$ 69.5	$ 90.6	$ 135.0	$ 173.2
Operating income (loss):				
Government Solutions	$ 1.8	$ 4.4	$ 2.6	$ (32.7)
Public Safety & Security	0.4	(0.4)	0.8	(0.8)
Unallocated Corporate income (expense), net	1.0	(0.2)	0.8	(1.4)
Total operating income (loss)	$ 3.2	$ 3.8	$ 4.2	$ (34.9)

For the six months ended June 28, 2009, the operating loss of the KGS segment includes a non-cash charge of $41.3 million related to goodwill impairment.

	As of December 28, 2008	As of June 29, 2009
Assets:		
Government Solutions	$ 275.9	$ 227.3
Public Safety & Security	12.2	9.1
Discontinued Operations	6.2	2.2
Corporate activities	18.1	11.2
Total assets	$ 312.4	$ 249.8

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 01-CV-4779. In the amended 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

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other public companies ("Issuers") that conducted IPOs of their common stock in the late 1990s and 2000. These complaints have been consolidated into an action captioned In re Initial Public Offering Securities Litigation, 21 MC 92 (the "IPO Cases").

In June 2004, the Issuers (including the Company) executed a partial settlement agreement with the plaintiffs that would have, among other things, resulted 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 district 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 of the settlement class 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 district court held a Final Fairness Hearing to determine whether to grant final approval of the settlement, and the court reserved decision at that time. While the partial settlement was pending approval, the plaintiffs continued to litigate against the underwriter defendants. The district court directed that the litigation proceed within a number of "focus cases" rather than all of the 310 cases that had been consolidated. The Company's case is not one of these focus cases. On October 13, 2004, the district court certified the focus cases as class actions. The underwriter defendants appealed that ruling and on December 5, 2006, the Second Circuit Court of Appeals reversed the district court's class certification decision. On April 6, 2007, the Second Circuit denied plaintiffs' rehearing petition, but clarified that the plaintiffs could seek to certify a more limited class in the district court. In light of the Second Circuit opinion, liaison counsel for all issuer defendants, including the Company, informed the district court that the settlement could not be approved because the defined settlement class, like the litigation class, could not be certified. On June 24, 2007, the district court entered an order terminating the proposed settlement.

Plaintiffs filed second consolidated amended complaints in the six focus cases on August 14, 2007, and, on September 27, 2007, again moved for class certification. On November 12, 2007, certain of the defendants in the focus cases moved to dismiss the second consolidated amended class action complaints. On March 26, 2008, the district court denied the motions to dismiss except as to section 11 claims raised by those plaintiffs who sold their securities for a price in excess of the initial offering price and those who purchased outside the previously certified class period. Briefing on the class certification motion was completed in May 2008. That motion was withdrawn without prejudice on October 10, 2008. On April 2, 2009, a stipulation and agreement of settlement among the plaintiffs, issuer defendants and underwriter defendants was submitted to the Court for preliminary approval. The Court granted the plaintiffs' motion for preliminary approval and preliminarily certified the settlement classes on June 10, 2009. Notice was sent to the settlement classes on July 2, 2009. The settlement fairness hearing has been scheduled for September 10, 2009. Following the hearing, if the Court determines that the settlement is fair to the class members, the settlement will be approved and the case against the Company and its individual defendants will be dismissed with prejudice. There can be no assurance that this proposed settlement will be approved and implemented in its current form, or at all. Due to the inherent uncertainties of litigation and because the settlement approval process is at a preliminary stage, the ultimate outcome of the matter is uncertain.

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 the Southern District of California. These actions were filed on behalf of those who purchased, or

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otherwise acquired, the Company's common stock between April 26, 2000 and August 4, 2004. The lawsuits generally alleged 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 alleged that Defendants violated the Securities Exchange Act of 1934, and the plaintiffs sought unspecified damages. These actions were consolidated into a single action In re Wireless Facilities, Inc. Securities Litigation, Master File 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. 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 Court granted preliminary approval of the proposed settlement on September 3, 2008. On January 13, 2009, following a motion by the parties, the Court granted final approval of the proposed settlement terms, issued its final judgment on the matter, and entered an order dismissing the case with prejudice.

Pursuant to the settlement agreement and final order of the Court, plaintiffs and the class dismissed 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 paid the settlement amount in accordance with the Company's insurance policies, less the applicable retention or co-insurance obligations that were paid directly by the Company. The Company's amount of payment toward the settlement was approximately $2.4 million. In the fourth quarter of 2008, the Company paid $3.0 million related to this matter, of which $1.0 million was from its restricted cash account. The Company received $0.6 million from the insurance carriers for this payment in the first quarter of 2009. Despite the settlement reached in this action, the Company believes that the allegations lacked 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 04CV1663; and Roth v. Wireless Facilities, Inc., Case 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 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

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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. Plaintiffs' opening appellate brief is due on September 25, 2009. The parties have conferred and discussed the Court's personal jurisdictional order, notice of appeal, and appellate briefing schedule 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 September 10, 2009. 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 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 intended to vigorously defend all claims asserted.

In August and September 2004, two virtually identical derivative lawsuits were filed in California Superior Court for San Diego County against certain of the Company's current and former officers and directors. These actions contain factual allegations similar to those of the federal lawsuits, but the plaintiffs in these cases assert claims for violations of California's insider trading laws, breaches of fiduciary duty, abuse of control, gross mismanagement, waste of corporate assets and unjust enrichment. The plaintiffs in these actions seek unspecified damages, equitable and/or injunctive relief and disgorgement of all profits, benefits and other compensation obtained by defendants. These lawsuits have been consolidated into one action In re Wireless Facilities, Inc. Derivative Litigation, California Superior Court, San Diego County, Lead Case GIC 834253. The plaintiffs filed a Consolidated Shareholder Derivative Complaint on October 14, 2004. This action has been stayed pending a decision in federal court on a motion to dismiss the federal derivative lawsuit. In April 2009, the parties notified the Court of the status of the federal action and the court continued the stay for an additional six months. The Court also ordered the parties to file an updated status report in October 2009. 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.

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The Company has recorded an accrual for a contingent liability associated with the legal proceedings related to the derivative actions of $0.7 million based on the Company's estimate of the potential amount it would have to pay in relation to these lawsuits.

2007 Securities Litigation

In March and April 2007, there were three federal class actions filed in the United States District Court for the Southern District of California against the Company and several of its current and former officers and directors. These class action lawsuits followed the Company's March 12, 2007 public announcement that it was conducting a voluntary internal review of its stock option granting processes. These actions were consolidated into a single action, In re Wireless Facilities, Inc. Securities Litigation II, Master File 07-CV-0482-BTM-NLS. The consolidated class action complaint was filed on November 19, 2007. In March 2008, following a voluntary mediation of the matter, the parties reached a tentative agreement to settle the class action. In May 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 Court granted preliminary approval of the proposed settlement on September 3, 2008. On December 19, 2008, following a motion by the parties, the Court granted final approval of the proposed settlement terms, issued its final judgment on the matter, and entered an order dismissing the case with prejudice.

Pursuant to the settlement agreement and final order of the Court, plaintiffs and the class dismissed all claims, with prejudice, in exchange for a cash payment in the amount of $4.5 million. The Company's directors' and officers' liability insurers paid the settlement amount, less the applicable retention or co-insurance obligations and contributions that were paid directly by the Company. In July 2008, the Company paid $1.8 million related to the settlement of this litigation. Despite the settlement reached in this action, the Company believes that the allegations lacked merit.

Other Litigation and Government Investigations

In January 2005, a former independent contractor of the Company filed a lawsuit in Brazil against the Company's subsidiary, WFI de Brazil, to which he had been assigned for a period of time. He sought to be designated an employee of WFI de Brazil and entitled to severance and related compensation pursuant to Brazilian labor law. The individual sought back wages, vacation pay, stock option compensation and related benefits in excess of $0.5 million. This matter was argued before the appropriate labor court in July 2005 and in July 2006, the labor court awarded the individual the Brazilian currency equivalent of approximately $0.5 million for his back wages, vacation pay and certain other benefits. The Company filed an appeal on the matter on July 20, 2006 and is challenging the basis for the award on several theories. The Company has accrued approximately $0.5 million as of June 28, 2009, related to this matter. On August 22, 2007, the appeals court partially upheld the Company's appeal, although it upheld the individual's designation as an employee. The court is reviewing possible damage calculations before publishing a final decision. The Company's counsel is preparing a motion for clarification of the judgment due to omissions in the decision.

On March 28, 2007, three plaintiffs, on behalf of a purported class of similarly situated employees and contractors, filed a lawsuit against the Company in the Superior Court of the State of California, Alameda County. The suit alleged various violations of the California Labor Code and sought payments for allegedly unpaid straight time and overtime, meal period pay and associated penalties. The Company and the plaintiffs agreed to venue for the suit in San Diego County. Although the Company believed that the allegations lack merit, it agreed with the plaintiffs to settle their claims for an aggregate amount in the range of $0.3 million to $0.5 million, to include individual and incentive awards, attorneys' fees and administrative costs. The court granted final approval of the settlement on

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April 17, 2009 and the Company has paid a total of $0.3 million in accordance with the final settlement.

On May 3, 2007, Kratos announced that it had filed a lawsuit against a former employee who previously served as its stock option administrator and left Kratos in mid-2004, and his spouse. The lawsuit sought to recover damages resulting from the theft by a former employee of Kratos stock options and common stock valued in excess of $6.3 million. The thefts, which appear to have taken place during 2002 and 2003, were discovered through the Kratos review of its past practices related to the granting and pricing of employee stock options with the assistance of its outside counsel and forensic computer consultants. The complaint also alleged that the former employee attempted to cover up the scheme by, among other things, deleting entries from the records of Kratos.

Kratos promptly reported to the SEC the discovery of the theft. The SEC initiated an inquiry and commenced an enforcement action against the former employee. The U.S. Attorney's Office also forwarded a grand jury subpoena to Kratos seeking records related to the former employee and Kratos' historical option granting practices. The SEC filed a federal lawsuit and obtained a temporary restraining order and asset freeze against the former employee and his spouse. The U.S. Attorney's Office indicted him for the theft and he pled guilty to federal criminal charges and has been sentenced to 46 months in prison and currently is incarcerated. On April 1, 2008, the SEC notified Kratos that it had completed its investigation and that it did not intend to recommend any enforcement action by the SEC against the Company. Kratos has cooperated with, and continues to cooperate with the U.S. Attorney's Office on this matter and otherwise. The former employee and his wife entered into a settlement agreement with Kratos on October 5, 2007, turning over substantially all of their assets to Kratos in settlement of the damages incurred in the theft. On February 15, 2008, the SEC approved the settlement. On February 19, 2008, the court entered a final judgment approving the settlement. Kratos has obtained the assets, which aggregate approximately $3.4 million and recovered $0.6 million from its insurance carrier related to the theft of options, and is in the process of liquidating the remaining assets which approximate $0.1 million in value. Kratos' directors' and officers' liability insurers agreed to reimburse it for $4.1 million in the third and fourth quarters of 2008 related to fees previously incurred on the ongoing investigation by the U.S. Attorney's Office as well as fees previously incurred on the SEC investigation.

On June 4, 2009, the Company filed a complaint in the United States District Court for the Northern District of Ohio against the lenders under its Credit Agreement, Field Point III, Ltd. and SPF CDO I, Ltd., both affiliates of Silverpoint Capital LP ("Silverpoint"), and KeyBank National Association ("KeyBank") seeking equitable relief in the form of reformation of an error in a contract schedule, declaratory relief and damages. The error resulted from the erroneous preparation of a schedule to the loan documents consisting of calculations related to a financial covenant. The Company is specifically seeking reformation of the error in the Minimum Liquidity Ratio covenant. The Company believes that the facts and the law support its claims.

KeyBank has agreed to reform the error, however, any reformation requires Silverpoint's consent which has not been provided. To date, the Company has met this covenant. As of June 28, 2009, the Company is in compliance with all financial covenants. However, as the magnitude of the error in the schedule increases in future periods, the Company believes that it will become more challenging to continue to manage around the error in the Minimum Liquidity Ratio covenant if the error is not corrected or the Company does not take alternative actions. In the event that this occurs, the Company intends to seek relief from the court.

In addition to the foregoing matters, from time to time, the Company may become involved in various claims, lawsuits and legal proceedings that arise in the ordinary course of business. However, litigation is subject to inherent uncertainties, and an adverse result in these or other matters may arise from time to time that may harm the Company's business. The Company is currently not aware of any such legal proceedings or claims that it believes will have, individually or in the aggregate, a material adverse affect on our business, financial condition, operating results or cash flows.

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

This report contains forward-looking statements. These statements relate to future events or our future financial performance. In some cases, you can identify forward-looking statements by terminology such as "may," "will," "should," "expect," "plan," "anticipate," "believe," "estimate," "predict," "potential" or "continue," the negative of such terms or other comparable terminology. These statements are only predictions. Actual events or results may differ materially. Factors that may cause our results to differ include, but are not limited to: changes in the scope or timing of our projects; changes or cutbacks in spending or the appropriation of funding by the federal government, including the U.S. Department of Defense, which could cause delays or cancellations of key government contracts; the timing, rescheduling or cancellation of significant customer contracts and agreements, or consolidation by or the loss of key customers; risks of adverse regulatory action or litigation; risks associated with debt leverage; failure to obtain court approval of the proposed litigation settlement or to ultimately settle the litigation; failure to successfully consummate acquisitions or integrate acquired operations; and competition in the marketplace which could reduce revenues and profit margins.

Although we believe that the expectations reflected in the forward-looking statements are reasonable, we cannot guarantee future results, levels of activity, performance or achievements. Moreover, neither we, nor any other person, assume responsibility for the accuracy and completeness of the forward-looking statements. We assume no obligation to update any of the forward-looking statements after the filing of this Quarterly Report on Form 10-Q to conform such statements to actual results or to changes in our expectations.

Certain of the information set forth herein, including costs and expenses that exclude the impact of stock-based compensation expense, amortization expense, certain legal fees and accrual for unused office space, may be considered non-GAAP financial measures. We believe this information is useful to investors because it provides a basis for measuring the operating performance of our business and our cash flow, excluding the effect of items that would normally be included in the most directly comparable measures calculated and presented in accordance with GAAP. Our management uses these non-GAAP financial measures along with the most directly comparable GAAP financial measures in evaluating our operating performance, capital resources and cash flow. Non-GAAP financial measures should not be considered in isolation from, or as a substitute for, financial information presented in compliance with GAAP, and non-financial measures as reported by Kratos may not be comparable to similarly titled amounts reported by other companies.

The following discussion should be read in conjunction with our unaudited condensed consolidated financial statements and the related notes and other financial information appearing elsewhere in this Form 10-Q. Readers are also urged to carefully review and consider the various disclosures made by us which attempt to advise interested parties of the factors which affect our business, including without limitation the disclosures made under the caption "Management's Discussion and Analysis of Financial Condition and Results of Operations," in Item 1A "Risk Factors" and the audited consolidated financial statements and related notes included in our Annual Report filed on Form 10-K for the year ended December 28, 2008 and other reports and filings made with the Securities and Exchange Commission.

Overview

We are an innovative provider of mission critical engineering, information technology (IT) services and warfighter solutions. We work primarily for the U.S. government and federal government agencies, but we also perform work for state and local agencies and commercial customers. Our principal services are related to, but are not limited to, Command, Control, Communications, Computing, Intelligence, Surveillance and Reconnaissance (C4ISR); weapons systems lifecycle support and sustainment; military weapon range operations and technical services; missile, rocket and weapons system test and evaluation; missile and rocket mission launch services; public safety, security and surveillance systems; modeling and simulation; unmanned aerial vehicle (UAV) products and technology; advanced network

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engineering and information technology services; and advanced information technology services. We offer our customers solutions and expertise to support their mission-critical needs by leveraging our skills across our core service areas.

We derive a substantial portion of our revenue from contracts performed for federal government agencies, including the U.S. Department of Defense (DOD), with the majority of our revenue currently generated from the delivery of mission-critical warfighter solutions, advanced engineering services, system integration and system sustainment services to defense and other non-DOD and civilian government agencies. We believe our diversified and stable client base, strong client relationships, broad array of contract vehicles, considerable employee base possessing government security clearances, extensive list of past performance qualifications, and significant management and operational capabilities position us for continued growth.

Prior to 2008, we were also an independent provider of outsourced engineering and network deployment services, security systems engineering and integration services and other technical services for the wireless communications industry, the U.S. government and enterprise customers. In 2006 and 2007, we undertook a transformation strategy whereby we divested our commercial wireless-related businesses and chose to pursue business with the federal government, primarily the DOD, through strategic acquisitions. On September 12, 2007, we changed our name from Wireless Facilities, Inc. to Kratos Defense & Security Solutions, Inc. Our new name reflects our revised focus as a defense contractor and security systems integrator for the federal government and for state and local agencies. In connection with our name change, we changed our NASDAQ Global Market trading symbol to "KTOS".

Current Reporting Segments

We operate in two principal business segments: Kratos Government Solutions (KGS) and Public Safety and Security (PSS). We organize our business segments based on the nature of the services offered. Transactions between segments are generally negotiated and accounted for under terms and conditions similar to other government and commercial contracts and these intercompany transactions are eliminated in consolidation. The financial statements in this Quarterly Report are presented in a manner consistent with our operating structure. For additional information regarding our operating segments, see Note 12 of Notes to Condensed Consolidated Financial Statements. From a customer and solutions perspective, we view our business as an integrated whole, leveraging skills and assets wherever possible.

Kratos Government Solutions (KGS) Segment

The Kratos Government Solutions segment provides engineering, information technology and weapons systems to federal, state, and local government agencies, but primarily the DOD. Our work includes weapon systems sustainment, lifecycle support and extension; C4ISR services; military range operations and technical services; missile, rocket, and weapons systems test and evaluation; mission launch services; modeling and simulation, unmanned aerial vehicle (UAV) products and technology, and advanced network engineering and information technology services; public safety, security and surveillance systems integration. Our KGS segment also provides public safety, security and surveillance systems products and services to the homeland security market with products and services aimed at supporting first responders.

Public Safety and Security (PSS) Segment

The Public Safety and Security segment provides system design, deployment, integration, monitoring and support services for public safety, security and surveillance networks for state and local governments and commercial customers. Public safety and security networks have been traditionally

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segregated into systems such as voice, data, access control, video surveillance, temperature control and fire and life safety. We provide services that combine such systems and offer integrated solutions on an Ethernet-based platform. We also offer solutions that combine voice, data, electronic security and building automation systems with fixed or wireless connectivity solutions. Our target markets are retail, healthcare, education, sports and entertainment, municipal government, correctional facilities and other public facilities. Our commitments to these markets and our ability to provide feature-rich, cost-effective solutions have allowed us to become one of the larger independent integrators for these types of systems. We maintain regional office locations comprised of Kratos Mid Atlantic, Kratos Southeast, and Kratos Southwest.

On June 24, 2009, as a result of the continued losses in the Southeast division of PSS, our Board of Directors approved a plan to sell and dispose of this division. The business unit was classified as held for sale and reported in discontinued operations in the accompanying Condensed Consolidated Financial Statements.

Recent Acquisitions

On June 28, 2008, we completed our acquisition of SYS, a San Diego-based company. The acquisition enhances our position as a premier mid-tier federal, state and local government contractor in the United States in the areas of C4ISR, IT services and public safety and homeland security solutions. The merger creates a broad, complementary set of business offerings, and positions us to deliver capabilities to a wider spectrum of customers.

We issued 25.3 million shares to SYS shareholders in the acquisition, for a total purchase price of $55.9 million including direct transaction costs of $2.4 million. Each share of SYS common stock was converted into the right to receive 1.2582 shares of Kratos common stock. The value of the Kratos common stock issued in the acquisition was derived from the number of shares of Kratos common stock issued, or 25.3 million, 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 the two days subsequent to the public announcement of the acquisition on February 21, 2008. Following the closing of the acquisition, we implemented a plan to restructure and/or exit certain business activities of SYS. The plan included a comprehensive assessment of personnel, relocation of personnel, facility consolidation and exit strategies for certain lines of business. The plan provided for approximately $2.0 million of restructuring costs associated with personnel, and additional costs of $0.5 million for facilities consolidation. The restructuring costs are primarily associated with the businesses sold and are accounted for in discontinued operations in the accompanying condensed consolidated financial statements.

In addition, we identified three business units of SYS that were not core to our business strategy and/or have been dilutive to profitability. We completed the sale of these businesses in the first quarter of 2009 for an aggregate cash consideration of approximately $0.4 million. We expect the divestiture of these businesses to slightly reduce revenues going forward, and increase profitability and cash flow. These businesses have been classified as discontinued operations in our condensed consolidated financial statements for the three and six months ended as of June 29, 2008 and June 28, 2009.

On December 24, 2008 we acquired Huntsville, Alabama based Digital Fusion, Inc. (DFI). DFI provides C4ISR and technical engineering services, UAV products and technology and has significant engineering, exotic sensor and modeling and simulation capabilities. The acquisition of DFI provides us with new customers and an expanded contract vehicle portfolio, in addition to expanding the range of service offerings to our existing customers. Principal customers of DFI include the Army Aviation and Missile Research, Development and Engineering Center (AMRDEC), Army Space and Missile Defense Command/Army Forces Strategic Command (ARSTRAT), NASA Marshall Space Flight Center, and certain classified customers.

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The total stock for stock transaction was valued at approximately $37.0 million, including transaction costs of $0.9 million. We issued 22.9 million shares to DFI shareholders and assumed outstanding DFI options, which resulted in the assumption of options to acquire approximately 10.0 million Kratos shares. 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 22.9 million, based on 12.8 million shares of DFI common stock outstanding and the exchange ratio of 1.7933 for each DFI share, at a price of $1.27 per share, the average closing price of Kratos shares of common stock for the two days prior to, including, and the two days subsequent to the public announcement of the merger on November 24, 2008. The fair value of the options assumed that were allocated to goodwill based upon the Black-Scholes pricing model was $7.0 million. The fair value of unvested options which are related to future service will be expensed as the service is performed.

For a complete description of our business and a discussion of our complete critical accounting matters, please refer to Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations," in our 2008 Annual Report on Form 10-K filed with the Securities and Exchange Commission on March 10, 2009.

As of June 28, 2009, we consider the following factors to be important in understanding our financial statements.

Kratos Government Solutions' business with the U.S. government and prime contractors is generally performed under cost reimbursable, fixed-price or time and materials contracts. Cost reimbursable contracts for the government provide for reimbursement of costs plus the payment of a fee. Some cost reimbursable contracts include incentive fees that are awarded based on performance on the contract. Under fixed-price contracts, we agree to perform certain work for a fixed price. Under time and materials contracts, we are reimbursed for labor hours at negotiated hourly billing rates and reimbursed for travel and other direct expenses at actual costs plus applied general and administrative expenses. Our Public Security and Safety contracts are primarily fixed-price contracts whereby revenue is recognized using the percentage-of-completion method of accounting under the provisions of Statement of Position (SOP) 81-1, *Accounting for Performance of Construction Type and Certain Production Type Contracts*. For contracts offered on a time and material basis, we recognize revenues as services are performed.

Cost of revenues includes direct compensation, living, travel and benefit expenses for project-related personnel, payments to third-party subcontractors, cost of materials, project-related incentive compensation based upon the successful achievement of certain project performance goals, allocation of overhead costs and other direct project-related expenses. Selling, general and administrative expenses include compensation and benefits for corporate service employees and similar costs for billable employees whose time and expenses cannot be assigned to a project (underutilization costs), expendable computer software and equipment, facilities expenses and other operating expenses not directly related and/or allocated to projects. General and administrative costs include all corporate and administrative functions that support existing operations and provide infrastructure to facilitate our future growth. Additionally, our sales personnel and senior corporate executives have, as part of their compensation packages, periodic and annual bonus/commission incentives based on the attainment of specified performance goals.

We consider the following factors when determining if collection of a receivable is reasonably assured: comprehensive collection history; results of our communications with customers; the current financial position of the customer; and the relevant economic conditions in the customer's country. If we have had no prior experience with the customer, we review reports from various credit organizations to ensure that the customer has a history of paying its creditors in a reliable and effective manner. If the financial condition of our customers were to deteriorate, and adversely affect their financial ability to make payments, additional allowances would be required. Additionally, on certain contracts whereby

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we perform services for a prime/general contractor, a specified percentage of the invoiced trade accounts receivable may be retained by the customer until we complete the project. We periodically review all retainages for collectibility and record allowances for doubtful accounts when deemed appropriate, based on our assessment of the associated risks.

We believe that our Kratos Government Solutions segment will build and expand our customer relationships within the DOD, Department of Homeland Security and other non-DoD state and local agencies by taking advantage of the significant opportunities for companies with substantial expertise in advanced engineering and information technology. We believe we will experience continued growth in revenues and operating income from this operating segment. The acquisitions of Haverstick on December 31, 2007, SYS on June 28, 2008, and DFI on December 24, 2008 resulted in the addition of over 1,000 highly skilled technical professionals and engineers with expertise in the areas of military weapons and target range support as well as targets and missile operations and maintenance.

Comparison of Results for the Three Months Ended June 29, 2008 to the Three Months Ended June 28, 2009

Revenues. Revenues increased $21.1 million from $69.5 million for the three months ended June 29, 2008 to $90.6 million for the three months ended June 28, 2009. This increase was primarily due to $32.4 million in aggregate revenues from SYS and DFI, which were acquired on June 28, 2008 and December 24, 2008, respectively, and partially offset by reductions in our commercial and public safety & security system integration business, which were negatively impacted by the current adverse economic environment, the substantial completion of a weapons system contract, and the planned reductions of acquired small business set aside contract work, pass through work and other contract work in our Government Solutions segment. Revenues by operating segment for the three months ended June 29, 2008 and June 28, 2009 are as follows (in millions):

	2008	2009	$ change	% change
Government Solutions	$59.2	$83.2	$ 24.0	40.5%
Public Safety & Security	10.3	7.4	(2.9)	(28.2)%
Total revenues	$69.5	$90.6	$ 21.1	30.4%

A portion of our revenue is derived from fixed-price contracts whereby revenue is calculated using the percentage-of-completion method based on the ratio of total costs incurred to date compared to estimated total costs to complete the contract. These estimates are reviewed monthly on a contract-by-contract basis, and are revised periodically throughout the life of the contract such that adjustments to profit resulting from revisions are made cumulative to the date of the revision. Significant management judgments and estimates, including the estimated costs to complete the project, which determine the project's percent complete, must be made and used in connection with the revenue recognized in any accounting period. Material differences may result in the amount and timing of our revenue for any period if management makes different judgments or utilizes different estimates.

Cost of Revenues. Cost of revenues increased from $57.0 million for the three months ended June 29, 2008 to $73.2 million for the three months ended June 28, 2009. The $16.2 million increase in cost of revenues was primarily a result of the increase in aggregate cost of revenues of $26.9 million from SYS and DFI, partially offset by reduced costs related to reductions in our commercial and public safety & security system integration business, which were negatively impacted by the current adverse economic environment, the substantial completion of a weapons system contract, and costs associated with the planned reductions of acquired small business set aside contract work, pass through work and other contract work in our government solutions business. Gross margin increased from 18.0% for the three months ended June 29, 2008 to 19.2% for the three months ended June 28, 2009. The increase in gross margin primarily resulted from a reduction in pass through work which has a lower margin and improved operating performance in the Government Solutions segment.

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Recovery of Unauthorized Issuance of Stock Options and Adjustment to the Liability for Unused Office Space. In the second quarter of 2008, our insurance carrier agreed to reimburse us for $0.6 million related to the theft of stock options and common stock by our former stock option administrator which occurred in 2002 and 2003. In addition, we reevaluated our excess facility accrual for obligations under facility leases and determined that a portion of our corporate facility would be used commencing in the third quarter of 2008. This change in estimate was primarily attributable to our acquisition of SYS which occurred on June 28, 2008. As a result we recorded a $0.6 million reversal in our excess facility accrual in the second quarter of 2008.

Selling, General and Administrative Expenses. Selling, general and administrative expenses (SG&A) increased from $10.5 million for the three months ended June 29, 2008 to $13.1 million for the three months ended June 28, 2009. The increase was primarily a result of $2.5 million in increased costs as a result of the SYS and DFI acquisitions. As a percentage of revenues, SG&A decreased from 15.1% to 14.5%. Excluding amortization of intangibles of $1.1 million for the three months ended June 29, 2008 and amortization of intangibles of $1.4 million for the three months ended June 28, 2009, SG&A decreased as a percentage of revenues from 13.5% to 12.9% for the three months ended June 29, 2008 and June 28, 2009, respectively, reflecting leverage on our increased revenues.

Research and Development Expenses. Research and development expenses (R&D) increased from zero for the three months ended June 29, 2008 to $0.5 million for the three months ended June 28, 2009 as a result of the R&D expenses incurred by SYS and DFI, which were acquired on June 28, 2008 and December 24, 2008, respectively.

Other Expense, Net. Other expense, net increased from $1.2 million to $3.2 million for the three months ended June 29, 2008 and June 28, 2009, respectively. The increase in expense of $2.0 million is primarily related to a $1.5 million increase in the non-cash charge to mark the derivative swap related to our credit facility to market. We had recorded non-cash income related to this swap of $1.3 million for the three months ended June 29, 2008 as compared to an expense of $0.2 million for the three months ended June 28, 2009. The increase in interest expense of $0.5 million from $2.5 million to $3.0 million in the three months ended June 28, 2009 was primarily related to an increase in interest expense for this derivative instrument and interest related to the subordinated debt which we assumed related to the SYS acquisition.

Provision for Income Taxes. Provision for income taxes decreased from a provision of $0.4 million, or a 20.0% rate, on income of $2.0 million before income taxes in the second quarter of 2008 to a provision of $0.3 million, or a 50% rate, on income before income taxes of $0.6 million. The provision for the second quarter of 2008 was primarily due to the increase in the deferred tax liability related to the temporary differences on indefinite life intangibles that were not offset by deferred tax assets due to the full valuation allowance we have recorded on these assets and certain state taxes. The tax provision in the second quarter of 2009 was primarily due to state taxes for certain states that are filed on a stand-alone basis and minimum taxes that we are subject to regardless of our income.

Loss from Discontinued Operations. Loss from discontinued operations increased from $0.8 million to $2.8 million for the three months ended June 29, 2008 and June 28, 2009, respectively. The loss in 2009 was primarily due to an impairment of assets related to the Southeast division of PSS of $2.0 million recorded to reflect management's estimates of fair value of this business. Revenues generated by these businesses were approximately $2.9 million and $1.3 million for the three months ended June 29, 2008 and June 28, 2009, respectively. Losses before taxes were $0.6 million for the three months ended June 29, 2008 and $0.6 million excluding the impairment charge for the three months ended June 28, 2009. Tax expense was $0.2 million for the three months ended June 29, 2008 and June 28, 2009 primarily related to foreign exchange adjustments and additional interest accrued for certain foreign tax contingencies.

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Comparison of Results for the Six Months Ended June 29, 2008 to the Six Months Ended June 28, 2009

Revenues. Revenues increased $38.2 million from $135.0 million for the six months ended June 29, 2008 to $173.2 million for the six months ended June 28, 2009. This increase was primarily due to $62.2 million in revenues from SYS and DFI, which were acquired on June 28, 2008 and December 24, 2008, respectively, partially offset by aggregate reductions in our commercial and public safety & security system integration business, which were negatively impacted by the current adverse economic environment, the substantial completion of a weapons system contract, and the planned reductions of acquired small business set aside contract work, pass through work and other contract work in our Government Solutions segment. Revenues by operating segment for the six months ended June 29, 2008 and June 28, 2009 are as follows (in millions):

	2008	2009	$ change	% change
Government Solutions	$114.1	$157.6	$ 43.5	38.1%
Public Safety & Security	20.9	15.6	(5.3)	(25.4)%
Total revenues	$135.0	$173.2	$ 38.2	28.3%

A portion of our revenue is derived from fixed-price contracts whereby revenue is calculated using the percentage-of-completion method based on the ratio of total costs incurred to date compared to estimated total costs to complete the contract. These estimates are reviewed monthly on a contract-by-contract basis, and are revised periodically throughout the life of the contract such that adjustments to profit resulting from revisions are made cumulative to the date of the revision. Significant management judgments and estimates, including the estimated costs to complete the project, which determine the project's percent complete, must be made and used in connection with the revenue recognized in any accounting period. Material differences may result in the amount and timing of our revenue for any period if management makes different judgments or utilizes different estimates.

Cost of Revenues. Cost of revenues increased from $110.3 million for the six months ended June 29, 2008 to $138.6 million for the six months ended June 28, 2009. The $28.3 million increase in cost of revenues was primarily a result of the increase in cost of revenues of $51.3 million from SYS and DFI, partially offset by reduced costs related to reductions in our commercial and public safety & security system integration business, which were negatively impacted by the current adverse economic environment, the substantial completion of a weapons systems contract, and costs associated with the planned reductions of acquired small business set aside contract work, pass through work and other contract work in our government solutions business. Gross margin increased from 18.3% to 20.0% for the six months ended June 29, 2008 and June 28, 2009, respectively. The increase in gross margin primarily resulted from a reduction in pass through work which has a lower margin and improved operating performance in the Government Solutions segment.

Selling, General and Administrative Expenses. Selling, general and administrative expenses (SG&A) increased from $21.7 million for the six months ended June 29, 2008 to $26.7 million for the six months ended June 28, 2009. The increase was a result of $5.4 million in increased costs from the SYS and DFI acquisitions offset partially by cost reduction efforts implemented. As a percentage of revenues, SG&A decreased from 16.1% to 15.4%. Excluding amortization of intangibles of $2.2 million for the six months ended June 29, 2008 and amortization of intangibles of $2.9 million for the six months ended June 28, 2009, SG&A decreased as a percentage of revenues from 14.4% to 13.7% for the six months ended June 29, 2008 and June 28, 2009, respectively, reflecting leverage on our increased revenues.

Recovery of Unauthorized Issuance of Stock Options and Adjustment to the Liability for Unused Office Space. In the second quarter of 2008, our insurance carrier agreed to reimburse us for $0.6 million related to the theft of stock options and common stock by our former stock option administrator which

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occurred in 2002 and 2003. In addition, we reevaluated our excess facility accrual for obligations under facility leases and determined that a portion of our corporate facility will be used commencing in the third quarter of 2008. This change in estimate was primarily attributable to our acquisition of SYS which occurred on June 28, 2008. As a result we recorded a $0.6 million reversal in our excess facility accrual in the second quarter of 2008. For the six months ended June 28, 2009 we recorded an expense of $0.6 million in our excess facility accrual as a result of the consolidation of space at our corporate headquarters following the sale of the SYS commercial businesses and as a result of the cancellation of a sublease of one of our tenants due to financial difficulties.

Research and Development Expenses. Research and development expenses (R&D) increased from zero for the six months ended June 29, 2008 to $0.9 million for the six months ended June 28, 2009 as a result of the R&D expenses incurred by SYS and DFI, which were acquired on June 28, 2008 and December 24, 2008, respectively.

Impairment of Goodwill. The impairment charge of $41.3 million is primarily driven by adverse equity market conditions that caused a decrease in current market multiples and our average stock price as of February 28, 2009, compared with the impairment test performed as of December 28, 2008. In our analysis, we use the income approach and validate its reasonableness by considering our market capitalization based upon an average of our stock price for a period prior to and subsequent to the date we perform our analysis. The average market price of our stock as of February 28, 2009 was $0.78 which equates to a 39% drop in our average stock price and corresponding market capitalization from December 28, 2008 which had an average stock price of $1.29. We reconcile the fair value of our reporting units which is calculated using the income approach to our market capitalization. As a result of this reconciliation, it was noted that investors were requiring a higher rate of return, and therefore, our discount factor which is based upon an estimated market participant weighted average cost of capital (WACC) increased 300 basis points from 14% in our year end impairment test in 2008 as compared to 17% in our 2009 first quarter interim impairment test. This change was the key factor contributing to the $41.3 million goodwill impairment charge that we recorded in the first quarter of 2009.

Our forecasts of growth rates and operating margins had not changed as of February 28, 2009 as compared to the forecasts which were used as of December 28, 2008. Our historical growth rates and operating results are not indicative of our future growth rates and operating results as a consequence of our transformation of the Company from a commercial wireless service provider to a U.S. government defense contractor. The decline in revenues on a pro forma basis after considering recent acquisitions, which was expected by us, is primarily due to the impact of the conversion of our work as a prime contractor under certain legacy small business awards to that of a subcontractor. This change resulted in an award of an overall smaller portion of the entire project as the contracts were recompeted and the original term of the small business contracts were completed. The conversion of work as a prime to a subcontractor related to legacy small business contracts awarded to acquired companies is not uncommon in the government defense contractor industry for companies that have been acquisitive. Our projected growth rates take into consideration this anticipated impact on small business awards. Our contracts are long term in nature and are supported by significant backlog. Because our contracts are of a long term nature, a majority of our receivables are with agencies within the U. S. government or we are a subcontractor to a customer whose receivables are with the agencies within the U.S. government, we are not subject to significant short term changes in operating cash flow. Moreover, because of the nature of our current business we do not have significant capital expenditure requirements. Additionally, our contract base is highly diversified and the loss of any one contract would not impact revenues by more than 3%. In addition, we did not assume a recovery of the global or national economy in our cash flow projections in either analysis.

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Other Expense, Net. Other expense, net increased from $3.9 million to $5.7 million for the six months ended June 29, 2008 and June 28, 2009, respectively. The increase in expense of $1.8 million is primarily related to a $1.1 million increase in other expense primarily related to the non-cash charges to mark the derivative related to our credit facility to market. The increase in interest expense of $0.7 million was primarily related to an increase in interest expense for this derivative instrument as well as interest expense on the subordinated debt which we assumed related to the SYS acquisition.

Provision for Income Taxes. Provision for income taxes decreased from a provision of $0.9 million, or a 300% rate, on income of $0.3 million before income taxes for the six months ended June 29, 2008 to a provision of $0.6 million, or a negative 0.1% rate, on a loss before income taxes of $40.6 million. The provision for the six months ended June 29, 2008 was primarily due to the increase in the deferred tax liability related to the temporary differences on indefinite life intangibles that were not offset by deferred tax assets due to the full valuation allowance we have recorded on these assets and certain state taxes. The tax provision in the six months ended June 28, 2009 was primarily due to state taxes for certain states that are filed on a stand-alone basis and minimum taxes that we are subject to regardless of our income.

Loss from Discontinued Operations. Loss from discontinued operations increased from $0.5 million to $3.4 million for the six months ended June 29, 2008 and June 28, 2009, respectively. In 2009, $2.0 million of the loss was related to the impairment of assets related to the Southeast division of PSS recorded to reflect managements estimate of the fair value of this business. Revenues generated by these businesses were approximately $5.5 million and $2.6 million for the six months ended June 29, 2008 and June 28, 2009, respectively. Losses before taxes were $1.4 million for the six months ended June 29, 2008 and $1.8 million excluding the impairment charge for the six months ended June 28, 2009. For the six months ended June 29, 2008 and June 28, 2009, we recognized a tax benefit of $0.9 million and $0.4 million, respectively, primarily related to the expiration of the statute of limitations for certain foreign tax contingencies.

Backlog

As of June 28, 2009, our backlog was approximately $640 million, of which $130 million was funded. Backlog is our estimate of the amount of revenue we expect to realize over the remaining life of awarded contracts and task orders that we have in hand as of the measurement date. Our total backlog consists of funded and unfunded backlog. We define funded backlog as estimated future revenue under government contracts and task orders for which funding has been appropriated by Congress and authorized for expenditure by the applicable agency, plus our estimate of the future revenue we expect to realize from our commercial contracts that are under firm orders. Our funded backlog does not include the full potential value of our contracts, because Congress often appropriates funds to be used by an agency for a particular program of a contract on a yearly or quarterly basis, even though the contract may call for performance over a number of years. As a result, contracts typically are only partially funded at any point during their term and all or some of the work to be performed under the contracts may remain unfunded unless and until Congress makes subsequent appropriation and the procuring agency allocates funding to the contract.

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

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

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

Liquidity and Capital Resources

As of June 28, 2009, we had consolidated cash and cash equivalents of $4.0 million, consolidated long-term and short-term debt of $76.2 million, and consolidated stockholders' equity of $102.9 million. Our principal sources of liquidity are cash flows from operations and borrowings under our credit facility.

Our operating cash flow is used to finance trade accounts receivable, fund capital expenditures, our ongoing operations, litigation and government inquiries, service our debt and make strategic acquisitions. Financing trade accounts receivable is necessary because, on average, our customers do not pay us as quickly as we pay our vendors and employees for their goods and services. Cash from continuing operations is primarily derived from our customer contracts in progress and associated changes in working capital components.

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

	Six months ended June 29, 2008	Six months ended June 28, 2009
Net cash provided by operating activities of continuing operations	$ 4.3	$ 13.3

Cash provided by operating activities from continuing operations for the six months ended June 28, 2009 increased by $9.0 million from the six months ended June 29, 2008, primarily as a result of increased cash collections on our accounts receivable balances resulting in the reduction of our Days Sales Outstanding from 107 days for the year ended December 28, 2008, to 90 days for the six months ended June 28, 2009, partially offset by payments related to accrued liabilities.

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Our cash provided by (used in) investing activities from continuing operations are summarized as follows (in millions):

	Six months ended June 29, 2008	Six months ended June 28, 2009
Investing activities:		
Cash paid for contingent acquisition consideration	$	$ (3.0)
Cash paid for acquisitions, net of cash acquired	1.0	(1.0)
Proceeds/(payments) from the disposition of discontinued operations	2.3	(1.1)
Other	(2.2)	(0.2)
Net cash provided by (used in) investing activities from continuing operations	$ 1.1	$ (5.3)

Cash paid for acquisitions and contingent acquisition consideration accounted for the most significant outlays for investing activities for the six months ended June 28, 2009 as a result of the implementation of our strategies to diversify our business while focusing on our core competencies. Cash paid for acquisitions for the six months ended June 29, 2008 relates to transaction costs paid for the Haverstick acquisition. Cash paid for contingent acquisition consideration for the six months ended June 28, 2009 relates to the final holdback payment of $2.4 million for the MRC acquisition and to the first holdback payment of $0.6 million related to the Haverstick acquisition. For the six months ended June 29, 2008 we received proceeds of $2.3 million from the settlement of the working capital amount owed by LCC on the sale of our domestic wireless engineering operations. For the six months ended June 28, 2009, we paid $1.5 million to Platinum Equity related to the working capital adjustment for the sale of our domestic wireless deployment business which was partially offset by proceeds of $0.4 million related to the sale of the discontinued SYS commercial businesses. Capital expenditures were $0.3 million for the six months ended June 29, 2008 and $0.2 million for the six months ended June 28, 2009. On August 3, 2009, Platinum Equity agreed to reduce the accrued interest by approximately $0.2 million. On August 4, 2009, the Company paid $1.3 million in full settlement of amounts due to Platinum Equity.

Cash provided by (used in) financing activities from continuing operations are summarized as follows (in millions):

	Six months ended June 29, 2008	Six months ended June 28, 2009
Financing activities:		
Payments of subordinated debt	$	$ (2.1)
Borrowings under credit facility	5.0	2.0
Repayments under credit facility	(0.7)	(5.6)
Other	(0.1)	0.1
Net cash provided by (used in) financing activities from continuing operations	$ 4.2	$ (5.6)

The decrease in cash in financing activities of $9.8 million from the six months ended June 29, 2008 to June 28, 2009 primarily relates to payments of $2.1 million on the subordinated debt we assumed in the SYS acquisition and principal payments under the terms of our Credit Facility.

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Cash used in discontinued operations are summarized as follows (in millions):

	Six months ended June 29, 2008	Six months ended June 28, 2009
Net cash flows of discontinued operations	$ (1.0)	$ (2.1)

The cash flow used by discontinued operations increased by $1.1 million primarily as a result of the use of cash by the SYS commercial businesses which were sold during the first quarter of 2009.

Contractual Obligations and Commitments

In connection with our historical business acquisitions, we have agreed to make additional future payments to sellers based on final purchase price adjustments and the expiration of certain indemnification obligations. Pursuant to the provisions of SFAS 141, such amounts are accrued, and therefore, recorded when the contingency is resolved beyond a reasonable doubt and, hence, the additional consideration becomes payable. As of June 28, 2009, we have approximately $0.6 million of cash holdback and 1.4 million shares of stock holdback that is due to be released in September 2009, subject to indemnity rights due to the Haverstick acquisition.

We have a credit facility of $85.0 million with KeyBank National Association ("KeyBank") as administrative agent. 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 $25.0 million revolving line of credit. KeyBank holds the revolving line of credit and the second lien term note. Field Point III, Ltd. and SPF CDO I, Ltd., both affiliates of Silverpoint Capital LP ("Silverpoint"), holds the first lien term note. 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 2010, 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. All loans under the 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 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. All rates are subject to a LIBOR floor of 4.25% and a "prime rate" floor of 5.25%.

As of June 28, 2009, our outstanding balance on the facility was $75.2 million and the weighted average interest rate on the debt as of June 28, 2009 was 10.53%. As of June 28, 2009, the unused line of credit under the revolving line of credit was approximately $3.2 million. The only restriction on the use of these funds is that we must be in compliance with covenants of the credit facility. We were in compliance with all covenants under the credit facility as of June 28, 2009.

As of December 28, 2008, we had outstanding convertible notes payable totaling $3.1 million which were acquired as a result of the SYS acquisition, of which $0.8 million was payable to related parties. The convertible notes payable are unsecured and subordinated to our bank debt and bear interest at 10% per annum payable quarterly. Principal was due February 14, 2009 and the notes were convertible at any time into shares of common stock at a conversion rate of $2.86 per share. In February 2009, in the interest of preserving cash due to the current macroeconomic conditions, the Company provided each note holder with the option to:

(1) Be paid cash in accordance with the original agreement;

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(2) Extend the note for an additional 18 months at the existing 10% rate and modify the conversion feature to the lower of the existing conversion price of $2.86 per share or the Kratos closing share value on February 13, 2009; or

(3) Convert the principal balance into Kratos shares at the lower of the existing conversion price of $2.86 or the Kratos closing share value on February 13, 2009 less a 10% discount.

As of June 28, 2009, $2.1 million of the notes had been paid and $1.0 million of the notes had been extended to August 14, 2010. The balance of the outstanding notes of $1.0 million, which is potentially convertible into common stock of Kratos at $1.02 per share or approximately 944,000 shares, is reflected in long-term debt in the accompanying condensed consolidated balance sheets.

Interest expense on the convertible notes was approximately $24,000 and $84,000 for the three and six month period ended June 28, 2009, respectively.

On July 16, 2008, we came to an agreement with Platinum Equity on a working capital adjustment of $5.0 million related to the sale of our wireless deployment business. In connection with that resolution, the earn-out arrangement was terminated. The adjustment was 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. We 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, with an additional $0.5 million paid in December 2008. In March 2009, we paid $1.5 million of the working capital adjustment. As of June 28, 2009, the balance of $1.0 million plus accrued interest on the outstanding balance has been reflected in other current liabilities in the accompanying condensed consolidated balance sheets. On August 3, 2009, Platinum Equity agreed to reduce the accrued interest by approximately $0.2 million. On August 4, 2009, the Company paid $1.3 million in full settlement of amounts due to Platinum Equity.

Other Liquidity Matters

We intend to fund our cash requirements with cash flows from operating activities, borrowings under our current credit facilities and potential future credit facilities. We believe these sources should be sufficient to meet our cash needs for at least the next 12 months. We expect that the acquired businesses of SYS and DFI, which were not included in our 2008 cash flows until the date of acquisition, will contribute additional working capital and cash flows.

In 2008, we paid approximately $4.8 million related to the 2004 and 2007 securities litigation settlements, as discussed in Note 13 Legal Matters to the unaudited consolidated financial statements included in Item 1 of Part I of this Quarterly Report. This amount was partially funded by $2.2 million from the restricted cash account we were required to fund as a result of the first amendment to our current credit facility. We also funded $5.5 million in 2008 for legal fees incurred on our internal stock option investigation which we completed in 2007. In addition, if we become subject to significant judgments, settlements, or fines related to the matters discussed in Note 13 Legal Matters, or any other matters, or incur legal fees in excess of our current expectations, we could be required to make significant payments that could materially and adversely affect our financial condition, potentially impacting our ability to access the capital markets and our compliance with our debt covenants.

As discussed in Part II, Item 1A, "Risk Factors" of this Quarterly Report on Form 10-Q, our quarterly and annual operating results have fluctuated in the past and may vary in the future due to a variety of factors, many of which are external to our control. If the conditions in our industry deteriorate or our customers cancel or postpone projects or if we are unable to sufficiently increase our revenues or further reduce our expenses, or if there changes in the status of litigation that results in payment of significant settlements or increased accruals for contingent liabilities, we may experience, in the future, a significant long-term negative impact to our financial results and cash flows from

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operations. In such a situation, we could fall out of compliance with our financial and other covenants which, if not waived, could limit our liquidity and capital resources and we could be unable to make a scheduled debt payment. We currently carry a significant amount of debt and have experienced recurring losses and negative cash flows from continuing operations. Given the highly leveraged liquidity position, any down-turn in our operating earnings or cash flows could impair our ability to comply with the financial covenants of our existing credit facility. Our ability to execute on additional business opportunities may be limited due to existing borrowing capacity. If we believe a covenant violation is more than likely to occur in the near future, we would seek relief from our lenders. This relief, if available, would have some cost to us and such relief might not be on terms as favorable as those in the existing credit agreement. If we were to actually default due to our failure to meet the financial covenants of our credit agreement and inability to obtain a waiver from the lenders, our credit agreement could require us to immediately repay all amounts then outstanding under the credit agreement and/or require us to pay interest at default rates per the credit agreement.

In the event we were required to repay the amount outstanding under the existing credit facility, we would need to obtain alternative sources of financing to continue our operating activities at existing levels. There can be no assurance that alternative financing would be available on acceptable terms or at all.

The credit agreements contain covenants which impose certain restrictions on our 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. As of June 28, 2009, we were in compliance with all financial covenants under the credit agreements.

On June 4, 2009, the Company filed a complaint in the United States District Court for the Northern District of Ohio against the lenders under its credit agreement, Field Point III, Ltd. and SPF CDO I, Ltd., both affiliates of Silverpoint, and KeyBank National Association seeking equitable relief in the form of reformation of an error in a contract schedule, declaratory relief and damages. The error resulted from the erroneous preparation of a schedule to the loan documents consisting of calculations relating to a financial covenant. The Company is specifically seeking reformation of the error in the Minimum Liquidity Ratio covenant.

KeyBank has agreed to reform the error; however, any reformation requires Silverpoint's consent, which has not been provided. To date, the Company has met this covenant without the requested reformation. However, because the magnitude of the error in the schedule increases in future periods, the Company believes that it will become more challenging to continue to manage around the error in the Minimum Liquidity Ratio covenant unless the error is corrected or the Company takes alternative actions. In the event that this occurs, the Company intends to seek relief from the court.

Critical Accounting Principles and Estimates

There have been no significant changes to our Critical Accounting Policies or Estimates during 2009. Refer to our Critical Accounting Policies and Estimates in Form 10-K for the year ended December 28, 2008, as filed with the Securities and Exchange Commission on March 10, 2009.

Goodwill and Purchased Intangibles. We perform our impairment test for goodwill in accordance with SFAS 142, *Goodwill and Other Intangible Asset*s. We assess goodwill for impairment at the reporting unit level, which is defined as an operating segment or one level below an operating segment, referred to as a component. We determine our reporting units by fist identifying our operating segments, and then assess whether any components of these segments constitute a business for which discrete financial information is available and where segment management regularly reviews the operating results of that component. We aggregate components within an operating segment that have

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similar economic characteristics. For our December 28, 2008 annual impairment assessment and our interim test as of February 28, 2009, we identified our reporting units to be our operating segments which are Government Solutions and Public Safety and Security.

We perform impairment tests for goodwill as of the last day of our fiscal year, or when evidence of potential impairment exists. When it is determined that impairment has occurred, a charge to operations is recorded. In order to test for potential impairment, we use the income approach, specifically the discounted cash flow (DCF) method, to derive the fair value of each of our reporting units and in order to validate the reasonableness of the income approach, we consider the market approach, which estimates the fair value of our reporting units based upon comparable market prices to validate the reasonableness of the implied multiples from the income approach. We also consider our market capitalization based upon an average of our stock price prior to and subsequent to the date we perform our analysis and reconcile the fair value of our reporting units to our market capitalization assuming a control premium.

In applying the income approach to our impairment test for goodwill, we make assumptions about the amount and timing of future expected cash flows, terminal growth rates, appropriate discount rates, and the control premium a controlling shareholder could be expected to pay:

The timing of future cash flows within our DCF analysis is based on our most recent forecasts and other estimates. Our historical growth rates and operating results are not indicative of our projected growth rates and operating results as a consequence of our acquisitions and divestitures and the transformation of the Company from a commercial wireless service provider to a U.S. government defense contractor. The decline in revenues on a pro forma basis after considering recent acquisitions, which was expected by us, is primarily due to the impact of the conversion of our work as a prime contractor under certain legacy small business awards to that of a subcontractor. This change resulted in an award of an overall smaller portion of the entire project as the contracts were recompeted and the original term of the small business contracts were completed. The conversion of work as a prime to a subcontractor related to legacy small business contracts awarded to the acquired companies is not uncommon in the government defense contractor industry for companies that have been acquisitive. Our projected growth rates take into consideration this anticipated impact on small business awards.

The current economic conditions have negatively impacted our Public Safety and Security reporting unit's projected growth rates and cash flows as customers have delayed or cancelled capital expenditures related to the systems we provide. However, this reporting unit has no goodwill, it is significantly smaller than our Government Solutions segment (for the quarter ended March 28, 2009, it generated 11.3% of our total consolidated revenues) and our goodwill impairment analysis is not materially affected by changes in the expected cash flows for this reporting unit. Current economic conditions have not significantly impacted our estimates of cash flows in our Government Solutions reporting unit which primarily provides services to the federal government and the DOD. Our contracts are long term in nature and are supported by significant backlog. Because our contracts are of a long term nature, a majority of our receivables are with agencies within the U. S. government or we are a subcontractor to a customer whose receivables are with the agencies within the U.S. government, we are not subject to significant short term changes in operating cash flow. As a result of our current business model, we do not have significant capital expenditure requirements. Additionally, our contract base is highly diversified and the loss of any one contract would not impact annual revenues by more than 3%.

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The terminal growth rate is used to calculate the value of cash flows beyond the last projected period in our DCF analysis and reflects our best estimates for stable, perpetual growth of our reporting units.

We use estimates of market participant weighted average cost of capital (WACC) as a basis for determining the discount rates to apply to our reporting units' future expected cash flows. The significant assumptions within our WACC are: (a) equity risk premium, (b) beta, (c) size premium adjustments, (d) cost of debt, and (e) capital structure assumptions. In addition, we use a company specific risk adjustment which is a subjective adjustment that, by its very nature does not include market related data, but instead examines the prospects of the reporting unit relative to the broader industry to determine if there are specific factors which may make it more "risky" relative to the industry.

We use an estimated control premium in reconciling the aggregate value of our reporting units to our market capitalization. As discussed in Statement of Financial Accounting Standards No. 142, *Goodwill and Other Intangible Assets*, (SFAS 142), control premiums may effectively cause a company's aggregate fair value of its reporting unit(s) to exceed its current market capitalization due to the ability of a controlling shareholder to benefit from synergies and other intangible assets that arise from such control. As a result, the measurement of fair value of an entity with a collection of assets and liabilities that operate together to produce cash flows is different from the fair value measurement of that entity's individual securities, hence, the reason a control premium is paid.

To test the sensitivity of our results to other outcomes that were reasonably likely to occur, we sensitized our forecasts for changes to revenue growth rates and operating margins, discount rates and long-term growth rates. None of these sensitized forecasts resulted in different conclusions with respect to goodwill impairment.

Our methodology for evaluating goodwill and intangibles for impairment is consistent with the methodology we have used in prior periods.

As a result of the assumptions used in our analyses, several factors could result in impairment of our $110.2 million goodwill and $29.3 million long-lived intangibles in future periods, including but not limited to:

a decline in our stock price and resulting market capitalization, if we determine the decline is sustained and is indicative of a reduction in the fair value below the carrying value of our government solutions reporting unit;

decreases in available government funding, including budgetary constraints affecting federal government spending generally, or specific departments or agencies;

changes in federal government programs or requirements, including the increased use of small business providers; and

our failure to reach our internal forecasts could impact our ability to achieve our forecasted levels of cash flows and reduce the estimated discounted value of our reporting units.

It is not possible at this time to determine if an impairment charge would result from these factors, or, if it does, whether such charge would be material.

Recent Accounting Pronouncements

In September 2006, the FASB issued SFAS 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

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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 157-3. 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 157-3 clarifies the principles in SFAS 157 on the fair value measurement of assets when the market for that asset is not active. The Company adopted SFAS 157 as of January 1, 2008. Refer to Note 9 to the Condensed Consolidated Financial Statements for additional discussion on fair value measurements.

In December 2007, the FASB issued SFAS 141R, "*Business Combinations*", (SFAS 141R). SFAS 141R establishes principles and requirements for how the acquirer of a business recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree. The statement also provides guidance for recognizing and measuring the goodwill acquired in the business combination and determines what information to disclose to enable users of financial statements to evaluate the nature and financial effects of the business combination. SFAS 141R is effective for financial statements issued for fiscal years beginning after December 15, 2008. Accordingly, any business combinations we engaged in were previously recorded and disclosed according to SFAS 141, *Business Combinations*, until December 28, 2008. The Company has adopted SFAS 141R as of December 29, 2008 and we expect SFAS 141R will have an impact on our consolidated financial statements, but the nature and magnitude of the effects will depend upon the nature, terms and size of the acquisitions we consummate after the effective date of December 29, 2008.

In December 2007, the FASB issued SFAS 160, "*Noncontrolling Interests in Consolidated Financial Statements an amendment of Accounting Research Bulletin 51*," (SFAS 160). SFAS 160 addresses the accounting and reporting standards for ownership interests in subsidiaries held by parties other than the parent, the amount of consolidated net income attributable to the parent and to the noncontrolling interest, changes in a parent's ownership interest, and the valuation of retained noncontrolling equity investments when a subsidiary is deconsolidated. SFAS 160 also establishes disclosure requirements that clearly identify and distinguish between the interests of the parent and the interests of the noncontrolling owners. SFAS 160 is effective for fiscal years beginning after December 15, 2008. The Company has adopted SFAS 160 as of December 29, 2008 and the adoption did not have a material impact on our consolidated financial statements.

In March 2008, the FASB issued SFAS 161, "*Disclosures about Derivative Instruments and Hedging Activities, an amendment of FASB Statement 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 has adopted SFAS 161 as of December 29, 2008 and the statement did not have a significant impact on the Company's consolidated financial statements (Refer to Note 10).

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In May 2009, the FASB issued SFAS No. 165, "*Subsequent Events*" (SFAS 165). SFAS 165 establishes general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued or are available to be issued. It requires the disclosure of the date through which an entity has evaluated subsequent events and the basis for selecting that date, that is, whether that date represents the date the financial statements were issued or were available to be issued. SFAS 165 is effective for interim or annual financial periods ending after June 15, 2009. The Company has adopted SFAS 165 as of June 28, 2009 and the adoption did not have a material impact on our consolidated financial statements.

As of June 28, 2009, the Company implemented FASB Staff Position FAS 107-1 and APB 28-1, "Interim Disclosures about Fair Value of Financial Instruments," (FSP FAS 107-1 and APB 28-1). FSP FAS 107-1 and APB 28-1, amends FASB Statement No. 107, Disclosures about Fair Value of Financial Instruments, to require disclosures about fair value of financial instruments in interim as well as in annual financial statements. This FSP also amends APB Opinion No. 28, Interim Financial Reporting, to require those disclosures in all interim financial statements. The FSP is effective for periods ending after June 15, 2009. In the second quarter of 2009, the Company implemented FSP FAS 107-1 and APB 28-1.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

We are exposed to market risk in connection with changes in interest rates, primarily in connection with outstanding balances under our credit facility with KeyBank Capital Markets. Based on our average outstanding balances during the six months ended June 28, 2009 a 1% change in the LIBOR rate would not impact our financial position and results of operations as a result of the 4.25% LIBOR floor rate on our credit facility. We manage exposure to these risks through our operating and financing activities and, when deemed appropriate, through the use of derivative financial instruments. Derivative financial instruments are viewed as risk management tools and are not used for speculation or for trading purposes. Derivative financial instruments are contracted with investment grade counterparties to reduce exposure to nonperformance on such instruments.

Cash and cash equivalents as of June 28, 2009 were $4.0 million and are primarily invested in money market interest bearing accounts. A hypothetical 10% adverse change in the average interest rate on our money market cash investments and short-term investments would have had no material effect on net income for the six month period ended June 28, 2009.

Item 4. Controls and Procedures

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

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

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foregoing, our Principal Executive Officer and Principal Financial Officer concluded that our disclosure controls and procedures were effective at the reasonable assurance level as of June 28, 2009.

There has been no change in our internal control over financial reporting during the quarter ended June 28, 2009 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

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 01-CV-4779. In the amended 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. These complaints have been consolidated into an action captioned In re Initial Public Offering Securities Litigation, 21 MC 92 (the "IPO Cases").

In June 2004, the Issuers (including the Company) executed a partial settlement agreement with the plaintiffs that would have, among other things, resulted 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 district 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 of the settlement class 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 district court held a Final Fairness Hearing to determine whether to grant final approval of the settlement, and the court reserved decision at that time. While the partial settlement was pending approval, the plaintiffs continued to litigate against the underwriter defendants. The district court directed that the litigation proceed within a number of "focus cases" rather than all of the 310 cases that had been consolidated. The Company's case is not one of these focus cases. On October 13, 2004, the district court certified the focus cases as class actions. The underwriter defendants appealed that ruling and on December 5, 2006, the Second Circuit Court of Appeals reversed the district court's class certification decision. On April 6, 2007, the Second Circuit denied plaintiffs' rehearing petition, but clarified that the plaintiffs could seek to certify a more limited class in the district court. In light of the Second Circuit opinion, liaison counsel for all issuer defendants, including the Company, informed the district court that the settlement could not be approved because the defined settlement class, like the litigation class, could not be certified. On June 24, 2007, the district court entered an order terminating the proposed settlement.

Plaintiffs filed second consolidated amended complaints in the six focus cases on August 14, 2007, and, on September 27, 2007, again moved for class certification. On November 12, 2007, certain of the

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defendants in the focus cases moved to dismiss the second consolidated amended class action complaints. On March 26, 2008, the district court denied the motions to dismiss except as to section 11 claims raised by those plaintiffs who sold their securities for a price in excess of the initial offering price and those who purchased outside the previously certified class period. Briefing on the class certification motion was completed in May 2008. That motion was withdrawn without prejudice on October 10, 2008. On April 2, 2009, a stipulation and agreement of settlement among the plaintiffs, issuer defendants and underwriter defendants was submitted to the Court for preliminary approval. The Court granted the plaintiffs' motion for preliminary approval and preliminarily certified the settlement classes on June 10, 2009. Notice was sent to the settlement classes on July 2, 2009. The settlement fairness hearing has been scheduled for September 10, 2009. Following the hearing, if the Court determines that the settlement is fair to the class members, the settlement will be approved and the case against the Company and its individual defendants will be dismissed with prejudice. There can be no assurance that this proposed settlement will be approved and implemented in its current form, or at all. Due to the inherent uncertainties of litigation and because the settlement approval process is at a preliminary stage, the ultimate outcome of the matter is uncertain.

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 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 alleged 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 alleged that Defendants violated the Securities Exchange Act of 1934, and the plaintiffs sought unspecified damages. These actions were consolidated into a single action In re Wireless Facilities, Inc. Securities Litigation, Master File 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. 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 Court granted preliminary approval of the proposed settlement on September 3, 2008. On January 13, 2009, following a motion by the parties, the Court granted final approval of the proposed settlement terms, issued its final judgment on the matter, and entered an order dismissing the case with prejudice.

Pursuant to the settlement agreement and final order of the Court, plaintiffs and the class dismissed 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 paid the settlement amount in accordance with

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the Company's insurance policies, less the applicable retention or co-insurance obligations that were paid directly by the Company. The Company's amount of payment toward the settlement was approximately $2.4 million. In the fourth quarter of 2008, the Company paid $3.0 million related to this matter, of which $1.0 million was from its restricted cash account. The Company received $0.6 million from the insurance carriers for this payment in the first quarter of 2009. Despite the settlement reached in this action, the Company believes that the allegations lacked 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 04CV1663; and Roth v. Wireless Facilities, Inc., Case 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 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. Plaintiffs' opening appellate brief is due on September 25, 2009. The parties have conferred and discussed the Court's personal jurisdictional order, notice of appeal, and appellate briefing schedule 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 September 10, 2009. 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 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

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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 intended to vigorously defend all claims asserted.

In August and September 2004, two virtually identical derivative lawsuits were filed in California Superior Court for San Diego County against certain of the Company's current and former officers and directors. These actions contain factual allegations similar to those of the federal lawsuits, but the plaintiffs in these cases assert claims for violations of California's insider trading laws, breaches of fiduciary duty, abuse of control, gross mismanagement, waste of corporate assets and unjust enrichment. The plaintiffs in these actions seek unspecified damages, equitable and/or injunctive relief and disgorgement of all profits, benefits and other compensation obtained by defendants. These lawsuits have been consolidated into one action In re Wireless Facilities, Inc. Derivative Litigation, California Superior Court, San Diego County, Lead Case GIC 834253. The plaintiffs filed a Consolidated Shareholder Derivative Complaint on October 14, 2004. This action has been stayed pending a decision in federal court on a motion to dismiss the federal derivative lawsuit. In April 2009, the parties notified the Court of the status of the federal action and the court continued the stay for an additional six months. The Court also ordered the parties to file an updated status report in October 2009. 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.

The Company has recorded an accrual for a contingent liability associated with the legal proceedings related to the derivative actions of $0.7 million based on the Company's estimate of the potential amount it would have to pay in relation to these lawsuits.

2007 Securities Litigation

In March and April 2007, there were three federal class actions filed in the United States District Court for the Southern District of California against the Company and several of its current and former officers and directors. These class action lawsuits followed the Company's March 12, 2007 public announcement that it was conducting a voluntary internal review of its stock option granting processes. These actions were consolidated into a single action, In re Wireless Facilities, Inc. Securities Litigation II, Master File 07-CV-0482-BTM-NLS. The consolidated class action complaint was filed on November 19, 2007. In March 2008, following a voluntary mediation of the matter, the parties reached a tentative agreement to settle the class action. In May 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 Court granted preliminary approval of the proposed settlement on September 3, 2008. On December 19, 2008, following a motion by the parties, the Court granted final approval of the proposed settlement terms, issued its final judgment on the matter, and entered an order dismissing the case with prejudice.

Pursuant to the settlement agreement and final order of the Court, plaintiffs and the class dismissed all claims, with prejudice, in exchange for a cash payment in the amount of $4.5 million. The Company's directors' and officers' liability insurers paid the settlement amount, less the applicable retention or co-insurance obligations and contributions that were paid directly by the Company. In July 2008, the Company paid $1.8 million related to the settlement of this litigation. Despite the settlement reached in this action, the Company believes that the allegations lacked merit.

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Other Litigation and Government Investigations

In January 2005, a former independent contractor of the Company filed a lawsuit in Brazil against the Company's subsidiary, WFI de Brazil, to which he had been assigned for a period of time. He sought to be designated an employee of WFI de Brazil and entitled to severance and related compensation pursuant to Brazilian labor law. The individual sought back wages, vacation pay, stock option compensation and related benefits in excess of $0.5 million. This matter was argued before the appropriate labor court in July 2005 and in July, 2006, the labor court awarded the individual the Brazilian currency equivalent of approximately $0.5 million for his back wages, vacation pay and certain other benefits. The Company filed an appeal in the matter on July 20, 2006 and is challenging the basis for the award on several theories. The Company has accrued approximately $0.5 million as of June 28, 2008 related to this matter. On August 22, 2007, the appeals court partially upheld the Company's appeal, although it upheld the individual's designation as an employee. The court is reviewing possible damage calculations before publishing a final decision. The Company's counsel is preparing a motion for clarification of the judgment due to omissions in the decision.

On March 28, 2007, three plaintiffs, on behalf of a purported class of similarly situated employees and contractors, filed a lawsuit against the Company in the Superior Court of the State of California, Alameda County. The suit alleged various violations of the California Labor Code and sought payments for allegedly unpaid straight time and overtime, meal period pay and associated penalties. The Company and the plaintiffs agreed to venue for the suit in San Diego County. Although the Company believed that the allegations lack merit, it agreed with the plaintiffs to settle their claims for an aggregate amount in the range of $0.3 million to $0.5 million, to include individual and incentive awards, attorneys' fees and administrative costs. The court granted final approval of the settlement on April 17, 2009 and the Company has paid a total of $0.3 million in accordance with the final settlement.

On May 3, 2007, Kratos announced that it had a filed a lawsuit against a former employee who previously served as its stock option administrator and left Kratos in mid-2004, and his spouse. The lawsuit sought to recover damages resulting from the theft by a former employee of Kratos stock options and common stock valued in excess of $6.3 million. The thefts, which appear to have taken place during 2002 and 2003, were discovered through the Kratos review of its past practices related to the granting and pricing of employee stock options with the assistance of its outside counsel and forensic computer consultants. The complaint also alleged that the former employee attempted to cover up the scheme by, among other things, deleting entries from the records of Kratos.

Kratos promptly reported to the SEC the discovery of the theft. The SEC initiated an inquiry and commenced an enforcement action against the former employee. The U.S. Attorney's Office also forwarded a grand jury subpoena to Kratos seeking records related to the former employee and Kratos' historical option granting practices. The SEC filed a federal lawsuit and obtained a temporary restraining order and asset freeze against the former employee and his spouse. The U.S. Attorney's Office indicted him for the theft and he pled guilty to federal criminal charges and has been sentenced to 46 months in prison and currently is incarcerated. On April 1, 2008, the SEC notified Kratos that it had completed its investigation and that it did not intend to recommend any enforcement action by the SEC against the Company. Kratos has cooperated with, and continues to cooperate with the U.S. Attorney's Office on this matter and otherwise. The former employee and his wife entered into a settlement agreement with Kratos on October 5, 2007, turning over substantially all of their assets to Kratos in settlement of the damages incurred in the theft. On February 15, 2008, the SEC approved the settlement. On February 19, 2008, the court entered a final judgment approving the settlement. Kratos has obtained the assets, which aggregate approximately $3.4 million and recovered $0.6 million from its insurance carrier related to the theft of options, and is in the process of liquidating the remaining assets which approximate $0.1 million in value. Kratos' directors' and officers' liability insurers agreed to reimburse it for $4.1 million in the third and fourth quarters of 2008 related to fees previously

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incurred on the ongoing investigation by the U.S. Attorney's Office as well as fees previously incurred on the SEC investigation.

On June 4, 2009, the Company filed a complaint in the United States District Court for the Northern District of Ohio against the lenders under its credit agreement, Field Point III, Ltd. and SPF CDO I, Ltd., both affiliates of Silverpoint, and KeyBank National Association seeking equitable relief in the form of reformation of an error in a contract schedule, declaratory relief and damages. The error resulted from the erroneous preparation of a schedule to the loan documents consisting of calculations relating to a financial covenant. The Company is specifically seeking reformation of the error in the Minimum Liquidity Ratio covenant.

KeyBank has agreed to reform the error; however, any reformation requires Silverpoint's consent, which has not been provided. To date, the Company has met this covenant without the requested reformation. However, because the magnitude of the error in the schedule increases in future periods, the Company believes that it will become more challenging to continue to manage around the error in the Minimum Liquidity Ratio covenant unless the error is corrected or the Company takes alternative actions. In the event that this occurs, the Company intends to seek relief from the court.

In addition to the foregoing matters, from time to time, the Company may become involved in various claims, lawsuits and legal proceedings that arise in the ordinary course of business. However, litigation is subject to inherent uncertainties, and an adverse result in these or other matters may arise from time to time that may harm the Company's business. The Company is currently not aware of any such legal proceedings or claims that it believes will have, individually or in the aggregate, a material adverse affect on our business, financial condition, operating results or cash flows.

Item 1A. Risk Factors

You should carefully consider the following risk factors and all other information contained herein as well as the information included in this Quarterly Report, and other reports and filings made with the SEC in evaluating our business and prospects. Risks and uncertainties, in addition to those we describe below, that are not presently known to us or that we currently believe are immaterial may also impair our business operations. If any of the following risks occur, our business and financial results could be harmed and the price of our common stock could decline. You should also refer to the other information contained in this report, including our unaudited condensed consolidated financial statements and related notes.

Our business could be adversely affected by changes in the contracting or fiscal policies of the federal government and governmental entities.

We derive a significant portion of our revenue from contracts with the U.S. federal government and government agencies and subcontracts under federal government prime contracts, and the success of our business and growth of our business will continue to depend on our successful procurement of government contracts either directly or through prime contractors. Accordingly, changes in government contracting policies or government budgetary constraints could directly affect our financial performance. Among the factors that could adversely affect our business are:

changes in fiscal policies or decreases in available government funding, including budgetary constraints affecting federal government spending generally, or specific departments or agencies in particular;

the adoption of new laws or regulations or changes to existing laws or regulations;

changes in political or social attitudes with respect to security and defense issues;

changes in federal government programs or requirements, including the increased use of small business providers;

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changes in or delays related to government restrictions on the export of defense articles and services;

potential delays or changes in the government appropriations process; and

delays in the payment of our invoices by government payment offices.

These and other factors could cause governments and government agencies, or prime contractors that use us as a subcontractor, to reduce their purchases under existing contracts, to exercise their rights to terminate contracts at-will or to abstain from exercising options to renew contracts, any of which could have an adverse effect on our business, financial condition and results of operations. Many of our government customers are subject to stringent budgetary constraints. The award of additional contracts from government agencies could be adversely affected by spending reductions or budget cutbacks at these agencies.

Recent deterioration in the credit markets and the financial services industry may negatively impact our business, results of operations, financial condition or liquidity.

Recently the credit markets and the financial services industry have been experiencing a period of unprecedented turmoil and upheaval characterized by the bankruptcy, failure, collapse or sale of various financial institutions and an unprecedented level of intervention from the United States federal government. While the outcome of these events cannot be predicted, they may have an adverse effect on our liquidity, financial condition and results of operations if it became necessary for us to acquire additional debt financing. Given our highly leveraged liquidity position, any down-turn in our operating earnings or cash flows could impair our ability to comply with the financial covenants of our existing credit facility. If additional debt financing were required, it may be at interest rates far greater than our current outstanding debt or may not be available at all.

Although we maintain allowances for doubtful accounts for estimated losses from the inability of our customers to make required payments and such losses have historically been within our expectations and the allowances we have established, we cannot guarantee that we will continue to experience the same loss rates we have in the past, especially given the recent deterioration of the credit markets. A significant change in the liquidity or financial condition of our customers could cause unfavorable trends in our revenue and receivable collections and additional allowances may be required. These additional allowances could materially affect our financial results.

Our ability to make payments on our debt will be contingent on our future operating performance, which will depend on a number of factors that are outside our control.

Our debt service obligations are estimated to be approximately $11.0 million to $13.0 million in 2009, including approximately $5.9 million of principal repayments. This debt service may have an adverse impact on our earnings and cash flow, which could in turn negatively impact our stock price.

Our ability to make principal and interest payments on our debt is contingent on our future operating performance, which will depend on a number of factors, many of which are outside of our control. The degree to which we are leveraged could have other important negative consequences, including the following:

we must dedicate a substantial portion of our cash flows from operations to the payment of our indebtedness, reducing the funds available for future working capital requirements, capital expenditures, acquisitions or other general corporate requirements;

a significant portion of our borrowings are, and will continue to be, at variable rates of interest, which may result in higher interest expense in the event of increases in interest rates;

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we may be more vulnerable to a downturn in the industries in which we operate or a downturn in the economy;

we may be limited in our flexibility to plan for, or react to, changes in our business and the industries in which we operate;

we may be placed at a competitive disadvantage compared to our competitors that have less debt;

we may determine it to be necessary to dispose of certain assets or one or more of our businesses to reduce our debt; and

our ability to borrow additional funds in excess of our current financing may be limited.

Our business may not generate sufficient cash flow from operations and future borrowings may not be available in amounts sufficient to enable us to pay our indebtedness or fund our other liquidity needs. Moreover, we may need to refinance all or a portion of our indebtedness on or before maturity. In such a case, we may not be able to refinance any of our indebtedness on commercially reasonable terms or at all. If we are unable to make scheduled debt payments or comply with the other provisions of our debt instruments, our lenders may be permitted under certain circumstances to accelerate the maturity of the indebtedness owed to them and exercise other remedies provided for in those instruments and under applicable law.

We have incurred and may continue to incur goodwill impairment charges in our reporting entities which could harm our profitability.

A significant portion of our net assets come from goodwill and other intangible assets. In accordance with Statement of Financial Accounting Standards, or SFAS 142, "*Goodwill and Other Intangible Assets*," (SFAS 142) we periodically review the carrying values of our goodwill to determine whether such carrying values exceed the fair market value. Our acquired companies are subject to annual review for goodwill impairment. If impairment testing indicates that the carrying value of a reporting unit exceeds its fair value, the goodwill of the reporting unit is deemed impaired. Accordingly, an impairment charge would be recognized for that reporting unit in the period identified. In 2008, as a result of our annual review, we recorded a goodwill impairment charge of $105.8 million related to our KGS segment, to reflect the declining market and economic conditions through December 28, 2008.

Given the continued significant decline in the stock market in general and specifically the impact on our stock price in 2009, we performed an impairment test for goodwill in accordance with SFAS 142 as of February 28, 2009. The test indicated that the book value for the KGS segment exceeded the fair values of the businesses and resulted in our recording a charge totaling $41.3 million in our KGS segment for the impairment of goodwill. The impairment charge is primarily driven by adverse equity market conditions that caused a decrease in current market multiples and our average stock price as of February 28, 2009, compared with the test performed as of December 28, 2008.

We derive a substantial amount of our revenues from the sale of our solutions either directly or indirectly to U.S. government entities pursuant to government contracts, which differ materially from standard commercial contracts, involve competitive bidding and may be subject to cancellation or delay without penalty, any of which may produce volatility in our revenues and earnings.

Government contracts frequently include provisions that are not standard in private commercial transactions, and are subject to laws and regulations that give the federal government rights and

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remedies not typically found in commercial contracts, including provisions permitting the federal government to:

- terminate our existing contracts;
- reduce potential future income from our existing contracts;
- modify some of the terms and conditions in our existing contracts;
- suspend or permanently prohibit us from doing business with the federal government or with any specific government agency;
- impose fines and penalties;
- subject us to criminal prosecution;
- suspend work under existing multiple year contracts and related task orders if the necessary funds are not appropriated by Congress;
- decline to exercise an option to extend an existing multiple year contract; and
- claim rights in technologies and systems invented, developed or produced by us.

In addition, government contracts are frequently awarded only after formal competitive bidding processes, which have been and may continue to be protracted and typically impose provisions that permit cancellation in the event that necessary funds are unavailable to the public agency. Competitive procurements impose substantial costs and managerial time and effort in order to prepare bids and proposals for contracts that may not be awarded to us. In many cases, unsuccessful bidders for government agency contracts are provided the opportunity to formally protest certain contract awards through various agencies, administrative and judicial channels. The protest process may substantially delay a successful bidder's contract performance, result in cancellation of the contract award entirely and distract management. We may not be awarded contracts for which we bid, and substantial delays or cancellation of purchases may follow our successful bids as a result of such protests.

Certain of our government contracts also contain "organizational conflict of interest" clauses that could limit our ability to compete for certain related follow-on contracts. For example, when we work on the design of a particular solution, we may be precluded from competing for the contract to install that solution. While we actively monitor our contracts to avoid these conflicts, we cannot guarantee that we will be able to avoid all organizational conflict of interest issues.

We may not receive the full amounts estimated under the contracts in our backlog, which could reduce our revenue in future periods below the levels anticipated and which makes backlog an uncertain indicator of future operating results.

As of June 28, 2009, our backlog was approximately $640 million, of which $130 million was funded. Funded backlog is estimated future revenue under government contracts and task orders for which funding has been appropriated by Congress and authorized for expenditure by the applicable agency, plus our estimate of the future revenue we expect to realize from our commercial contracts that are under firm orders. Although funded backlog represents only business which is considered to be firm, cancellations or scope adjustments may still occur. The remaining $510 million is unfunded backlog, which reflects our estimate of future revenue under awarded government contracts and task orders for which either funding has not yet been appropriated or expenditure has not yet been authorized. Unfunded backlog does not include estimates of revenue from GWAC contracts or GSA schedules beyond awarded or funded task orders, but does include estimates of revenue beyond awarded or funded task orders for other types of IDIQ contracts. The amount of unfunded backlog is not exact or guaranteed and is based upon,

among other things, management's experience under such contracts and similar contracts, the particular clients, the type of work and budgetary expectations. Our

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management may not accurately assess these factors or estimate the revenue we will realize from these contracts, and our unfunded and total backlog may not reflect the actual revenue ultimately received from these contracts.

Backlog is typically subject to large variations from quarter to quarter and comparisons of backlog from period to period are not necessarily indicative of future revenues. The contracts comprising our backlog may not result in actual revenue in any particular period or at all, and the actual revenue from such contracts may differ from our backlog estimates. The timing of receipt of revenues, if any, on projects included in backlog could change because many factors affect the scheduling of projects. Cancellation of or adjustments to contracts may occur. Additionally, all United States government contracts included in backlog, whether or not funded, may be terminated at the convenience of the United States government. The failure to realize all amounts in our backlog could adversely affect our revenues and gross margins. As a result, our funded and total backlog as of any particular date may not be an accurate indicator of our future earnings.

We face intense competition from many competitors that have greater resources than we do, which could result in price reductions, reduced profitability or loss of market share.

We operate in highly competitive markets and generally encounter intense competition to win contracts from many other firms, including mid-tier federal contractors with specialized capabilities and large defense and IT services providers. Competition in our markets may increase as a result of a number of factors, such as the entrance of new or larger competitors, including those formed through alliances or consolidation. These competitors may have greater financial, technical, marketing and public relations resources, larger client bases and greater brand or name recognition than we do. These competitors could, among other things:

- divert sales from us by winning very large-scale government contracts, a risk that is enhanced by the recent trend in government procurement practices to bundle services into larger contracts;
- force us to charge lower prices; or
- adversely affect our relationships with current clients, including our ability to continue to win competitively awarded engagements in which we are the incumbent.

If we lose business to our competitors or are forced to lower our prices, our revenue and our operating profits could decline. In addition, we may face competition from our subcontractors who, from time-to-time, seek to obtain prime contractor status on contracts for which they currently serve as a subcontractor to us. If one or more of our current subcontractors are awarded prime contractor status on such contracts in the future, it could divert sales from us or could force us to charge lower prices, which could cause our margins to suffer.

Recent acquisitions and potential future acquisitions could prove difficult to integrate, disrupt our business, dilute stockholder value and strain our resources.

We have completed several acquisitions of complementary businesses in recent years, including our December 2007 acquisition of Haverstick Consulting, Inc., our June 2008 acquisition of SYS, and our December 2008 acquisition of DFI. The success of the acquisitions will depend in part on the success of integrating the operations, technologies and personnel of SYS and DFI. The failure to successfully integrate the operations of the two companies or otherwise to realize any of the anticipated benefits of the acquisitions could seriously harm our results of operations.

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We continually evaluate opportunities to acquire new businesses as part of our ongoing strategy and we may in the future acquire additional companies that we believe could complement or expand our business or increase our customer base. Acquisitions involve numerous risks, including:

- difficulties in integrating operations, technologies, accounting and personnel;
- difficulties in supporting and transitioning customers of acquired companies;
- difficulties or delays in transitioning federal government contracts pursuant to federal acquisition regulations;
- diversion of financial and management resources from existing operations;
- potential loss of key employees;
- federal acquisition regulations may require us to enter into government novation agreements, a potentially time-consuming process; and
- inability to generate sufficient revenue to offset acquisition costs.

Acquired companies may have liabilities or adverse operating issues that we fail to discover through due diligence prior to the acquisition. In particular, to the extent that prior owners of any acquired businesses or properties failed to comply with or otherwise violated applicable laws or regulations, or failed to fulfill their contractual obligations to the federal government or other clients, we, as the successor owner, may be financially responsible for these violations and failures and may suffer reputational harm or otherwise be adversely affected. Acquisitions also frequently result in the recording of goodwill and other intangible assets which are subject to potential impairments in the future that could harm our financial results. In addition, if we finance acquisitions by issuing convertible debt or equity securities, our existing stockholders may be diluted, which could affect the market price of our stock. As a result, if we fail to properly evaluate acquisitions or investments, we may not achieve the anticipated benefits of any such acquisitions, and we may incur costs in excess of what we anticipate.

Our financial results may vary significantly from quarter to quarter.

We expect our revenue and operating results to vary from quarter to quarter. Reductions in revenue in a particular quarter could lead to lower profitability in that quarter because a relatively large amount of our expenses are fixed in the short-term. We may incur significant operating expenses during the start-up and early stages of large contracts and may not be able to recognize corresponding revenue in that same quarter. We may also incur additional expenses when contracts expire, are terminated or are not renewed.

In addition, payments due to us from federal government agencies may be delayed due to billing cycles or as a result of failures of government budgets to gain congressional and administration approval in a timely manner. The federal government's fiscal year ends September 30. If a federal budget for the next federal fiscal year has not been approved by that date in each year, our clients may have to suspend engagements that we are working on until a budget has been approved. Any such suspensions may reduce our revenue in the fourth quarter of that year or the first quarter of the subsequent year. The federal government's fiscal year end can also trigger increased purchase requests from clients for equipment and materials. Any increased purchase requests we receive as a result of the federal government's fiscal year end would serve to increase our third or fourth quarter revenue, but will generally decrease profit margins for that quarter, as these activities generally are not as profitable as our typical offerings.

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Additional factors that may cause our financial results to fluctuate from quarter to quarter include those addressed elsewhere in these Risk Factors and the following, among others:

- the terms of customer contracts that affect the timing of revenue recognition;
- variability in demand for our services and solutions;
- commencement, completion or termination of contracts during any particular quarter;
- timing of award or performance incentive fee notices;
- timing of significant bid and proposal costs;
- variable purchasing patterns under GSA Schedule 70 contracts, government wide acquisition contracts (GWACs), blanket purchase agreements and other indefinite delivery/indefinite quantity contracts;
- restrictions on and delays related to the export of defense articles and services;
- costs related to ongoing government inquiries;
- strategic decisions by us or our competitors, such as acquisitions, divestitures, spin-offs and joint ventures;
- strategic investments or changes in business strategy;
- changes in the extent to which we use subcontractors;
- seasonal fluctuations in our staff utilization rates;
- changes in our effective tax rate including changes in our judgment as to the necessity of the valuation allowance recorded against our deferred tax assets; and
- the length of sales cycles.

Significant fluctuations in our operating results for a particular quarter could cause us to fall out of compliance with the financial covenants contained in our credit facility, which if not waived by the lender, could restrict our access to capital and cause us to take extreme measures to pay down our debt under the credit facility. In addition, fluctuations in our financial results could cause our stock price to decline.

If we fail to establish and maintain important relationships with government entities and agencies and other government contractors, our ability to bid successfully for new business may be adversely affected.

To develop new business opportunities, we primarily rely on establishing and maintaining relationships with various government entities and agencies. We may be unable to successfully maintain our relationships with government entities and agencies, and any failure to do so could

materially adversely affect our ability to compete successfully for new business. In addition, we often act as a subcontractor or in "teaming" arrangements in which we and other contractors bid together on particular contracts or programs for the federal government or government agencies. As a subcontractor or team member, we often lack control over fulfillment of a contract, and poor performance on the contract could tarnish our reputation, even when we perform as required. We expect to continue to depend on relationships with other contractors for a portion of our revenue in the foreseeable future. Moreover, our revenue and operating results could be materially adversely affected if any prime contractor or teammate chooses to offer a client services of the type that we provide or if any prime contractor or teammate teams with other companies to independently provide those services.

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We derive a significant portion of our revenues from a limited number of customers.

We have derived, and believe that we will continue to derive, a significant portion of our revenues from a limited number of customers. To the extent that any significant customer uses less of our services or terminates its relationship with us, our revenues could decline significantly. As a result, the loss of any significant client could seriously harm our business. For the three and six months ended June 28, 2009, two customers comprised approximately 63% and 62% of our federal business revenues and total revenues, respectively, and our five largest customers accounted for approximately 75% and 74% of our total federal business revenues and total revenues, respectively. None of our customers are obligated to purchase additional services from us. As a result, the volume of work that we perform for a specific customer is likely to vary from period to period, and a significant client in one period may not use our services in a subsequent period.

Our margins and operating results may suffer if we experience unfavorable changes in the proportion of cost-plus-fee or fixed-price contracts in our total contract mix.

Although fixed-price contracts entail a greater risk of a reduced profit or financial loss on a contract compared to other types of contracts we enter into, fixed-price contracts typically provide higher profit opportunities because we may be able to benefit from cost savings. In contrast, cost-plus-fee contracts are subject to statutory limits on profit margins, and generally are the least profitable of our contract types. Our federal government customers typically determine what type of contract we enter into. Cost-plus-fee and fixed-price contracts in our federal business accounted for approximately 34% and 32%, respectively, of our federal business revenues for the six months ended June 28, 2009. To the extent that we enter into more cost-plus-fee or less fixed-price contracts in proportion to our total contract mix in the future, our margins and operating results may suffer.

Our cash flow and profitability could be reduced if expenditures are incurred prior to the final receipt of a contract.

We provide various professional services and sometimes procure equipment and materials on behalf of our federal government customers under various contractual arrangements. From time to time, in order to ensure that we satisfy our customers' delivery requirements and schedules, we may elect to initiate procurement in advance of receiving final authorization from the government customer or a prime contractor. If our government or prime contractor customers' requirements should change or if the government or the prime contractor should direct the anticipated procurement to a contractor other than us or if the equipment or materials become obsolete or require modification before we are under contract for the procurement, our investment in the equipment or materials might be at risk if we cannot efficiently resell them. This could reduce anticipated earnings or result in a loss, negatively affecting our cash flow and profitability.

Loss of our GSA contracts or GWACs would impair our ability to attract new business.

We are a prime contractor under several GSA contracts and GWAC schedule contracts. We believe that our ability to provide services under these contracts will continue to be important to our business because of the multiple opportunities for new engagements each contract provides. If we were to lose our position as prime contractor on one or more of these contracts, we could lose substantial revenues and our operating results could suffer. GSA contracts and other GWACs typically have a one or two-year initial term with multiple options exercisable at the government client's discretion to extend the contract for one or more years. We cannot be assured that our government clients will continue to exercise the options remaining on our current contracts, nor can we be assured that our future clients will exercise options on any contracts we may receive in the future.

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Failure to properly manage projects may result in additional costs or claims.

Our engagements often involve large scale, highly complex projects. The quality of our performance on such projects depends in large part upon our ability to manage the relationship with our customers, and to effectively manage the project and deploy appropriate resources, including third-party contractors, and our own personnel, in a timely manner. Any defects or errors or failure to meet clients' expectations could result in claims for substantial damages against us. Our contracts generally limit our liability for damages that arise from negligent acts, error, mistakes or omissions in rendering services to our clients. However, we cannot be sure that these contractual provisions will protect us from liability for damages in the event we are sued. In addition, in certain instances, we guarantee customers that we will complete a project by a scheduled date. If the project experiences a performance problem, we may not be able to recover the additional costs we will incur, which could exceed revenues realized from a project. Finally, if we underestimate the resources or time we need to complete a project with capped or fixed fees, our operating results could be seriously harmed.

The loss of any member of our senior management could impair our relationships with federal government clients and disrupt the management of our business.

We believe that the success of our business and our ability to operate profitably depends on the continued contributions of the members of our senior management. We rely on our senior management to generate business and execute programs successfully. In addition, the relationships and reputation that many members of our senior management team have established and maintain with federal government personnel contribute to our ability to maintain strong client relationships and to identify new business opportunities. We do not have any employment agreements providing for a specific term of employment with any member of our senior management. The loss of any member of our senior management could impair our ability to identify and secure new contracts, to maintain good client relations and to otherwise manage our business.

If we fail to attract and retain skilled employees or employees with the necessary security clearances, we might not be able to perform under our contracts or win new business.

The growth of our business and revenue depends in large part upon our ability to attract and retain sufficient numbers of highly qualified individuals who have advanced information technology and/or engineering skills. These employees are in great demand and are likely to remain a limited resource in the foreseeable future. Certain federal government contracts require us, and some of our employees, to maintain security clearances. Obtaining and maintaining security clearances for employees involves a lengthy process, and it is difficult to identify, recruit and retain employees who already hold security clearances. In addition, some of our contracts contain provisions requiring us to staff an engagement with personnel that the client considers key to our successful performance under the contract. In the event we are unable to provide these key personnel or acceptable substitutions, the client may terminate the contract and we may lose revenue.

If we are unable to recruit and retain a sufficient number of qualified employees, our ability to maintain and grow our business could be limited. In a tight labor market, our direct labor costs could increase or we may be required to engage large numbers of subcontractor personnel, which could cause our profit margins to suffer. Conversely, if we maintain or increase our staffing levels in anticipation of one or more projects and the projects are delayed, reduced or terminated, we may underutilize the additional personnel, which would increase our general and administrative expenses, reduce our earnings and possibly harm our results of operations.

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If our subcontractors fail to perform their contractual obligations, our performance and reputation as a prime contractor and our ability to obtain future business could suffer.

As a prime contractor, we often rely upon other companies to perform work we are obligated to perform for our clients as subcontractors. As we secure more work under our GWAC vehicles, we expect to require an increasing level of support from subcontractors that provide complementary and supplementary services to our offerings. Depending on labor market conditions, we may not be able to identify, hire and retain sufficient numbers of qualified employees to perform the task orders we expect to win. In such cases, we will need to rely on subcontracts with unrelated companies. Moreover, even in favorable labor market conditions, we anticipate entering into more subcontracts in the future as we expand our work under our GWACs. We are responsible for the work performed by our subcontractors, even though in some cases we have limited involvement in that work.

If one or more of our subcontractors fail to satisfactorily perform the agreed-upon services on a timely basis or violate federal government contracting policies, laws or regulations, our ability to perform our obligations as a prime contractor or meet our clients' expectations may be compromised. In extreme cases, performance or other deficiencies on the part of our subcontractors could result in a client terminating our contract for default. A termination for default could expose us to liability, including liability for the agency's costs of procurement, could damage our reputation and could hurt our ability to compete for future contracts.

Our failure to comply with complex procurement laws and regulations could cause us to lose business and subject us to a variety of penalties.

We must comply with laws and regulations relating to the formation, administration and performance of federal government contracts, which affect how we do business with our clients, prime contractors, subcontractors and vendors and may impose added costs on us. In addition, the federal government, including the Defense Contract Audit Agency (DCAA), audits and reviews our performance on contracts, pricing practices, cost structure and compliance with applicable laws, regulations and standards. The DCAA reviews a contractor's internal control systems and policies, including the contractor's purchasing, property, estimating, compensation and management information systems, and the contractor's compliance with such policies. Any costs found to be improperly allocated to a specific contract will not be reimbursed, while such costs already reimbursed must be refunded. Adverse findings in a DCAA audit could materially affect our competitive position and result in a substantial adjustment to our revenue and profit.

If a federal government audit uncovers improper or illegal activities, we may be subject to civil and criminal penalties and administrative sanctions, including termination of contracts, forfeiture of profits, suspension of payments, fines and suspension or debarment from doing business with federal government agencies. In addition, we could suffer serious harm to our reputation and competitive position if allegations of impropriety were made against us, whether or not true. If our reputation or relationship with federal government agencies were impaired, or if the federal government otherwise ceased doing business with us or significantly decreased the amount of business it does with us, our revenue and operating profit would decline.

The commercial business arena in which we operate has relatively low barriers to entry and increased competition could result in margin erosion, which would make profitability even more difficult to sustain.

Other than the technical skills required in our commercial business, the barriers to entry in this area are relatively low. We do not have any intellectual property rights in this segment of our business to protect our methods, and business start-up costs do not pose a significant barrier to entry. The success of our commercial business is dependent on our employees, customer relations and the successful performance of our services. If we face increased competition as a result of new entrants in

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our markets, we could experience reduced operating margins and loss of market share and brand recognition.

If our commercial customers do not invest in security systems and other new in-building technologies such as wireless local area networks and/or IP-based networks, our business will suffer.

We intend to devote significant resources to developing our enterprise-based wireless local area networks (WLAN), but we cannot predict that we will achieve widespread market acceptance amongst the enterprises we identify as potential customers. It is possible that some enterprises will determine that capital constraints and other factors outweigh their need for WLAN systems. As a result, we may be affected by a significant delay in the adoption of WLAN by enterprises, which would harm our business.

If we experience systems or service failure, our reputation could be harmed and our clients could assert claims against us for damages or refunds.

We create, implement and maintain IT solutions that are often critical to our clients' operations. We have experienced, and may in the future experience, some systems and service failures, schedule or delivery delays and other problems in connection with our work. If we experience these problems, we may:

lose revenue due to adverse client reaction;

be required to provide additional services to a client at no charge;

receive negative publicity, which could damage our reputation and adversely affect our ability to attract or retain clients; and

suffer claims for substantial damages.

In addition to any costs resulting from product or service warranties, contract performance or required corrective action, these failures may result in increased costs or loss of revenue if clients postpone subsequently scheduled work or cancel, or fail to renew, contracts.

While many of our contracts limit our liability for consequential damages that may arise from negligence in rendering services to our clients, we cannot assure you that these contractual provisions will be legally sufficient to protect us if we are sued. In addition, our errors and omissions and product liability insurance coverage may not be adequate, may not continue to be available on reasonable terms or in sufficient amounts to cover one or more large claims, or the insurer may disclaim coverage as to some types of future claims. The successful assertion of any large claim against us could seriously harm our business. Even if not successful, these claims could result in significant legal and other costs, may be a distraction to our management and may harm our reputation.

Security breaches in sensitive federal government systems could result in the loss of clients and negative publicity.

Many of the systems we develop, install and maintain involve managing and protecting information involved in intelligence, national security and other sensitive or classified federal government functions. A security breach in one of these systems could cause serious harm to our business, damage our reputation and prevent us from being eligible for further work on sensitive or classified systems for federal government clients. We could incur losses from such a security breach that could exceed the policy limits under our errors and omissions and product liability insurance. Damage to our reputation or limitations on our eligibility for additional work resulting from a security breach in one of the systems we develop, install and maintain could materially reduce our revenue.

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Our employees may engage in misconduct or other improper activities, which could cause us to lose contracts.

We are exposed to the risk that employee fraud or other misconduct could occur. Misconduct by employees could include intentional failures to comply with federal government procurement regulations, engaging in unauthorized activities or falsifying time records. Employee misconduct could also involve the improper use of our clients' sensitive or classified information, which could result in regulatory sanctions against us and serious harm to our reputation and could result in a loss of contracts and a reduction in revenues. It is not always possible to deter employee misconduct, and the precautions we take to prevent and detect this activity may not be effective in controlling unknown or unmanaged risks or losses, which could cause us to lose contracts or cause a reduction in revenues. In addition, alleged or actual employee misconduct could result in investigations or prosecutions of employees engaged in the subject activities, which could result in unanticipated consequences or expenses and management distraction for us regardless of whether we are alleged to have any responsibility.

Our business is dependent upon our ability to keep pace with the latest technological changes.

The market for our services is characterized by rapid change and technological improvements. Failure to respond in a timely and cost effective way to these technological developments would result in serious harm to our business and operating results. We have derived, and we expect to continue to derive, a substantial portion of our revenues from providing innovative engineering services and technical solutions that are based upon today's leading technologies and that are capable of adapting to future technologies. As a result, our success will depend, in part, on our ability to develop and market service offerings that respond in a timely manner to the technological advances of our customers, evolving industry standards and changing client preferences.

If we are unable to manage our growth, our business could be adversely affected.

Sustaining our growth has placed significant demands on our management, as well as on our administrative, operational and financial resources. For us to continue to manage our growth, we must continue to improve our operational, financial and management information systems and expand, motivate and manage our workforce. If we are unable to manage our growth while maintaining our quality of service and profit margins, or if new systems that we implement to assist in managing our growth do not produce the expected benefits, our business, prospects, financial condition or operating results could be adversely affected.

We may be harmed by intellectual property infringement claims and our failure to protect our intellectual property could enable competitors to market products and services with similar features.

We may become subject to claims from our employees or third parties who assert that software and other forms of intellectual property that we use in delivering services and solutions to our clients infringe upon intellectual property rights of such employees or third parties. Our employees develop some of the software and other forms of intellectual property that we use to provide our services and solutions to our clients, but we also license technology from other vendors. If our employees, vendors, or other third parties assert claims that we or our clients are infringing on their intellectual property rights, we could incur substantial costs to defend those claims. If any of these infringement claims are ultimately successful, we could be required to cease selling or using products or services that incorporate the challenged software or technology, obtain a license or additional licenses from our employees, vendors, or other third parties, or redesign our products and services that rely on the challenged software or technology.

We attempt to protect our trade secrets by entering into confidentiality and intellectual property assignment agreements with third parties, our employees and consultants. However, these agreements

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can be breached and, if they are, there may not be an adequate remedy available to us. In addition, others may independently discover our trade secrets and proprietary information and in such cases we could not assert any trade secret rights against such party. Enforcing a claim that a party illegally obtained and is using our trade secret is difficult, expensive and time consuming, and the outcome is unpredictable. If we are unable to protect our intellectual property, our competitors could market services or products similar to our services and products, which could reduce demand for our offerings. Any litigation to enforce our intellectual property rights, protect our trade secrets or determine the validity and scope of the proprietary rights of others could result in substantial costs and diversion of resources, with no assurance of success.

The matters relating to our internal review of our stock option granting practices and the restatement of our financial statements have exposed us to civil litigation claims, regulatory proceedings and government proceedings, which could have a material adverse effect on us.

In the summer of 2006, our current executive management team, which has been in place since 2004, initiated an investigation of our past stock option granting practices (the "Equity Award Review") in reaction to media reports regarding stock option granting practices of public companies. The Equity Award Review was conducted with oversight from the Board and assistance from our outside counsel. In February 2007, the Board appointed a Special Committee of the Board to review the adequacy of the Equity Award Review and the recommendations of management regarding historical option granting practices, and to make recommendations and findings regarding those practices and individual conduct. The Special Committee was not charged with making, and did not make, any evaluation of the accounting determinations or tax adjustments. The Special Committee was comprised of a non-employee director who had not served on our Compensation Committee before 2005.

The Equity Award Review encompassed all grants of options to purchase shares of our common stock and other equity awards made since two months prior to our IPO in November 1999 through December 2006. We also reviewed all option grants that were entered into our stock option database (Equity Edge) after our IPO with a grant date before November 1999, as well as other substantial grants issued prior to our IPO, consisting of more than 14,000 grants. We further reviewed all option grants with a grant date that preceded an employee's date of hire. As part of the review, interviews of 18 current and former officers, directors, employees and attorneys were conducted, and more than 40 million pages of electronic and hard copy documents were searched for relevant information. The Special Committee also conducted its own separate review of the option granting practices during the tenure of current executive management team through additional interviews and document collection and review with the assistance of its own separate counsel and FTI Consulting.

The Equity Award Review established the absence of contemporaneous evidence supporting a substantial number of the previously-recorded option grants, substantially all of which were made in the period from 1998 through late 2003. During this period of time, in some instances, documents, data and interviews suggest that option grants were prepared or finalized days or, in some cases, weeks or months after the option grant date recorded in our books. The affected grants include options issued to certain newly-hired employees but dated prior to their employment start dates and options issued to non-employees, including advisors to the Board erroneously designated as employees. The Special Committee also concluded that certain former employees and former officers participated in making improper option grants, including the selection of grant dates with the benefit of hindsight and in the deferral of the recording of otherwise approved option grants.

In light of the Equity Award Review, the Audit Committee of our Board concluded that our prior financial statements for periods from 1998 through our filing of interim financial statements for the period ended September 30, 2006, could no longer be relied upon and must be restated. Our management determined that, from fiscal year 1998 through fiscal year 2005, we had unrecorded non-cash equity-based compensation charges associated with our equity incentive plans. These charges

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are material to our financial statements for the years ended December 31, 1998 through 2005, the periods to which such charges would have related. Previously filed annual reports on Form 10-K and quarterly reports on Form 10-Q affected by the restatements have not been and will not be amended and should not be relied upon. Our Annual Report on Form 10-K filed on September 11, 2007 superseded and replaced in their entirety all of our previously issued financial statements and related reports filed with the Securities and Exchange Commission.

Our past stock option granting practices and the restatement of our prior financial statements have exposed and may continue to expose us to greater risks associated with litigation, regulatory proceedings and government inquiries and enforcement actions. As described in Part I, Item 3, "Legal Proceedings," several derivative complaints have been filed in state and federal courts against our current directors, some of our former directors and some of our current and former executive officers pertaining to allegations relating to stock option grants. The SEC initiated an inquiry into our historical stock option granting practices, and we received a subpoena from the United States Attorney's Office for the Southern District of California for the production of documents relating to our historical stock option granting practices.

In April 2008, the SEC notified us that it had completed its investigation and that it did not intend to recommend any enforcement action by the SEC against us. We have cooperated and expect to continue to cooperate with the U.S. Attorney's Office.

The period of time necessary to resolve the U.S. Attorney's Office inquiry is uncertain, and we cannot predict the outcome of this inquiry or whether we will face additional government inquiries, investigations or other actions related to our historical stock option grant practices. Subject to certain limitations, we are obligated to indemnify our current and former directors, officers and employees in connection with the investigation of our historical stock option practices, the completed SEC and pending U.S. Attorney's Office inquiries and any future government inquiries, investigations or actions. These inquiries could require us to expend significant management time and incur significant legal and other expenses, and could result in civil and criminal actions seeking, among other things, injunctions against us and the payment of significant fines and penalties by us, which could have a material adverse effect on our financial condition, business, results of operations and cash flow.

If a federal government investigation uncovers improper or illegal activities, including any potential improper or illegal activities related to our stock option review or related matters, we may be subject to civil and criminal penalties and administrative sanctions, including termination of contracts, forfeiture of profits, suspension of payments, fines and suspension or debarment from doing business with federal government agencies. The aggregate and ongoing legal fees associated with the investigation and defense of the matters related to the Equity Award Review are significant, but the impact has been partially mitigated by funds available under insurance policies purchased in prior years. We cannot assure you that the insurers will continue to reimburse us for ongoing fees. Moreover, the insurance policies contain a number of provisions that the insurers could assert either to discontinue payments or even to seek the return of previously made payments. For instance, if it were determined by final adjudication in the underlying action or in a separate action or proceeding that former officers or directors committed deliberate fraudulent or criminal acts, then insurers could assert that coverage under our directors and officer's liability insurance policies for those periods could be rescinded. In the event of such a determination and an assertion by an insurer, the insurance carriers could pursue a claim against the former officers and directors and/or us for amounts previously advanced under the underlying policies. If insurance coverage is withheld or rescinded by our insurance carriers, we could be exposed to potentially significant financial burdens arising from continuing to fund ongoing costs and costs associated with potential claims for return of prior payments, which could cause us significant harm. In addition, we could suffer serious harm to our reputation and competitive position if allegations of impropriety were made against us, whether or not true. If our reputation or relationship with federal government agencies were impaired, or if the federal government otherwise ceased doing

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business with us or significantly decreased the amount of business it does with us, our revenue and operating profit would decline.

If we fail to maintain an effective system of internal controls, we may not be able to accurately report our financial results or prevent fraud.

Effective internal controls are necessary for us to provide reliable financial reports. If we cannot provide reliable financial reports, our operating results could be misstated, our reputation may be harmed and the trading price of our stock could be negatively affected. Our management has concluded that there are no material weaknesses in our internal controls over financial reporting as of December 28, 2008. However, there can be no assurance that our controls over financial processes and reporting will be effective in the future or that additional material weaknesses or significant deficiencies in our internal controls will not be discovered in the future. Any failure to remediate any future material weaknesses or implement required new or improved controls, or difficulties encountered in their implementation, could harm our operating results, cause us to fail to meet our reporting obligations or result in material misstatements in our financial statements or other public disclosures. Inferior internal controls could also cause investors to lose confidence in our reported financial information, which could have a negative effect on the trading price of our stock. In addition, from time to time we acquire businesses which could have limited infrastructure and systems of internal controls.

On June 28, 2008, we completed the acquisition of SYS and on December 24, 2008, we completed the acquisition of DFI and, as permitted by SEC guidance, we excluded from our assessment of the effectiveness of our internal control over financial reporting as of December 28, 2008, the internal control over financial reporting of these two entities. These operations will be included in our assessment of internal controls over financial reporting for the year ending December 27, 2009. Performing assessments of internal controls, implementing necessary changes, and maintaining an effective internal controls process is costly and requires considerable management attention, particularly in the case of newly acquired entities.

We may need additional capital in the future to fund the growth of our business, and financing may not be available.

We currently anticipate that our available capital resources, including our credit facility and operating cash flows, will be sufficient to meet our expected working capital and capital expenditure requirements for at least the next 12 months. However, such resources may not be sufficient to fund the long-term growth of our business or the expenses associated with the ongoing litigation, litigation settlements and government inquiries. In particular, we may experience a negative operating cash flow due to billing milestones and project timelines in certain of our contracts.

We may raise additional funds through public or private debt or equity financings if such financings become available on favorable terms or we may expand our credit facility to fund future acquisitions and for general corporate purposes. However, due to the current challenges in the lending markets, we can provide no assurance that the lender would agree to extend additional or continuing credit under that facility. We could fall out of compliance with financial and other covenants contained in our credit facility which, if not waived, would restrict our access to capital and could require us to pay down our existing debt under the credit facility. Any new financing or offerings would likely dilute our stockholders' equity ownership. In addition, additional financing may not be available on terms favorable to us, or at all. If adequate funds are not available or are not available on acceptable terms, we may not be able to take advantage of available opportunities, develop new products or otherwise respond to competitive pressures. In any such case, our business, operating results or financial condition could be materially adversely affected.

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We are subject to restrictive debt covenants pursuant to our indebtedness. These covenants may restrict our ability to finance our business and, if we do not comply with the covenants or otherwise default under them, we may not have the funds necessary to pay all amounts that could become due and the lenders could foreclose on substantially all of our assets.

Our indebtedness contains covenants that, among other things, significantly restricts and, in some cases, effectively eliminates our ability and the ability of our subsidiaries to:

incur additional debt;

create or incur liens;

bid on or perform work due to limits on the amount of performance bonds that may be secured by letters of credit;

pay dividends or make other equity distributions to our stockholders;

make investments;

sell assets;

issue or become liable on a guarantee;

create or acquire new subsidiaries;

effect a merger or consolidation of, or sell all or substantially all of our assets; and

raise capital using our equity.

In addition, we must comply with certain financial covenants. In the event we were to fail to meet any of such covenants and were unable to cure such breach or otherwise renegotiate such covenants, our lenders would have significant rights to deny future access to liquidity and/or seize control of substantially all of our assets. The material financial covenants with which we must comply 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.

The covenants contained in our indebtedness and any credit agreement governing future debt may significantly restrict our future operations. Furthermore, upon the occurrence of any event of default, our lenders could elect to declare all amounts outstanding under such agreements, together with accrued interest, to be immediately due and payable. If those lenders were to accelerate the payment of those amounts, we may not have sufficient assets to repay those amounts in full.

On June 4, 2009, the Company filed a complaint in the United States District Court for the Northern District of Ohio against the lenders under its credit agreement, Field Point III, Ltd. and SPF CDO I, Ltd., both affiliates of Silverpoint, and KeyBank National Association seeking equitable relief in the form of reformation of an error in a contract schedule, declaratory relief and damages. The error resulted from the erroneous preparation of a schedule to the loan documents consisting of calculations relating to a financial covenant. The Company is specifically seeking reformation of the error in the Minimum Liquidity Ratio covenant.

KeyBank has agreed to reform the error; however, any reformation requires Silverpoint's consent, which has not been provided. To date, the Company has met this covenant without the requested reformation. However, because the magnitude of the error in the schedule increases in future periods, the Company believes that it will become more challenging to continue to manage around the error in the Minimum Liquidity

Ratio covenant unless the error is corrected or the Company takes alternative actions.

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We are also subject to interest rate risk due to our indebtedness at variable interest rates, based on a base rate or LIBOR floor rate plus an applicable margin. Shifts in interest rates could have a material adverse effect on us.

We may be required to prepay our indebtedness prior to its stated maturity, which may limit our ability to pursue business opportunities.

Pursuant to the terms of certain of our indebtedness, in certain instances we are required to prepay outstanding indebtedness prior to its stated maturity date. Specifically, 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. These prepayment provisions may limit our ability to utilize this cash flow to pursue business opportunities.

Our stock price may be volatile, which may result in lawsuits against us and our officers and directors.

The stock market in general and the stock prices of government services companies in particular, have experienced volatility that has often been unrelated to or disproportionate to the operating performance of those companies. The market price of our common stock has fluctuated in the past and is likely to fluctuate in the future. Factors which could have a significant impact on the market price of our common stock include, but are not limited to, the following:

quarterly variations in operating results;

announcements of new services by us or our competitors;

the gain or loss of significant customers;

changes in analysts' earnings estimates;

rumors or dissemination of false information;

pricing pressures;

short selling of our common stock;

impact of litigation and ongoing government inquiries;

general conditions in the market;

political and/or military events associated with current worldwide conflicts; and

events affecting other companies that investors deem comparable to us.

Companies that have experienced volatility in the market price of their stock have frequently been the subject of securities class action litigation. We and certain of our current and former officers and directors have been named defendants in class action and derivative lawsuits. These matters and any other securities class action litigation and derivative lawsuits in which we may be involved could result in substantial costs to us and a diversion of our management's attention and resources, which could materially harm our financial condition and results of operations.

Our charter documents and Delaware law may deter potential acquirers and may depress our stock price.

Certain provisions of our charter documents and Delaware law, as well as certain agreements we have with our executives, could make it substantially more difficult for a third party to acquire control of us. These provisions include:

authorizing the board of directors to issue preferred stock;

prohibiting cumulative voting in the election of directors;

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prohibiting stockholder action by written consent;

establishing advance notice requirements for nominations for election to our board of directors or for proposing matters that can be acted on by stockholders at meetings of our stockholders;

Section 203 of the Delaware General Corporation Law, which prohibits us from engaging in a business combination with an interested stockholder unless specific conditions are met; and

a number of our executives have agreements with us that entitle them to payments in certain circumstances following a change in control.

We have a stockholder rights plan which may discourage certain types of transactions involving an actual or potential change in control and may limit our stockholders' ability to approve transactions that they deem to be in their best interests. As a result, these provisions may depress our stock price.

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

On March 31, 2009, we issued 1.4 million shares to the former shareholders of Haverstick Consulting, Inc. in payment of the stock portion of the holdback consideration pursuant to the Agreement and Plan of Merger, dated November 2, 2007. These shares were issued without registration under the Securities Act of 1933, as amended (the "Securities Act"), in reliance upon the exemption provided by Section 4(2) under the Securities Act and Regulation D there under.

Item 3. Defaults Upon Senior Securities.

None.

Item 4. Submission of Matters to a Vote of Security Holders.

At the Company's Annual Meeting of Stockholders held on June 4, 2009, the following individuals were re-elected as directors of the Company for one-year terms: Scott I. Anderson, Bandel L. Carano, Eric M. DeMarco, William A. Hoglund and Scot B. Jarvis, and Samuel N. Liberatore who was elected by the stockholders after being appointed as a director by the board in January 2009. For each elected director the results of the voting were:

	Affirmative Votes	Votes Withheld
Scott I. Anderson	111,860,221	3,365,743
Bandel L. Carano	109,396,346	5,829,618
Eric M. DeMarco	112,835,107	2,390,857
William A. Hoglund	111,967,314	3,258,650
Scot B. Jarvis	111,879,549	3,346,415
Samuel N. Liberatore	113,105,123	2,120,841

At the Annual Meeting our stockholders also voted to approve the following proposals:

Approve an Amendment to our Amended and Restated Certificate of Incorporation effecting a reverse stock split. The results of the voting on this proposal were:

Affirmative Votes	Negative Votes	Abstentions	Broker Non-Votes
109,382,036	5,562,265	281,672	0

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Ratification of the selection of Grant Thornton LLP as the Company's independent registered public accounting firm for the fiscal year ending December 27, 2009. The results of the voting on this proposal were:

Affirmative Votes	Negative Votes	Abstentions	Broker Non-Votes
114,341,726	448,242	436,004	0

Item 5. Other Information.

None.

Item 6. Exhibits

Exhibit Number	Exhibit Description	Incorporated by Reference Form	Filing Date/ Period End Date	Filed Furnished Herewith
3.1	Amended and Restated Bylaws of Kratos Defense & Security Solutions, Inc. as amended June 4, 2009	8-K	6/10/2009	
31.1	Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes Oxley Act of 2002			*
31.2	Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes Oxley Act of 2002			*
32.1	Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002			*
32.2	Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002			*

*
Filed-Furnished Herewith

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SIGNATURES

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

KRATOS DEFENSE & SECURITY SOLUTIONS, INC.

By: /s/ ERIC M. DEMARCO

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

By: /s/ DEANNA H. LUND, CPA

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

By: /s/ LAURA L. SIEGAL

Laura L. Siegal
Vice President, Corporate Controller and
(Principal Accounting Officer)

Date: August 6, 2009