KRATOS DEFENSE & SECURITY SOLUTIONS, INC.
Form 10-K
March 02, 2011

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

(Mark One)

ý **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE FISCAL YEAR ENDED DECEMBER 26, 2010**

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

4820 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)

SECURITIES REGISTERED PURSUANT TO SECTION 12(b) OF THE ACT:

Title of Each Class	Name of each exchange on which registered
Common Stock, par value $0.001	The NASDAQ Global Select Market
Right to Purchase Shares of Series C Preferred Stock	

SECURITIES REGISTERED PURSUANT TO SECTION 12(g) OF THE ACT:

None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes o No ý

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes o No ý

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 issuer 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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ý

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

Large Accelerated Filer o	Accelerated Filer ý	Non-Accelerated Filer o (Do not check if a smaller reporting company)	Smaller Reporting Company o

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

The aggregate market value of the registrant's voting and non-voting stock common stock (together, the "Common Stock") held by non-affiliates as of the last business day of the most recently completed second fiscal quarter (June 27, 2010) was approximately $150.9 million, based on the closing sale price on the NASDAQ Global Select Market on that date.*

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* Excludes the Common Stock held by executive officers, directors and stockholders whose individual ownership exceeds 10% of the Common Stock outstanding on June 27, 2010. This calculation does not reflect a determination that such persons are affiliates for any other purpose.

The number of shares outstanding of Common Stock was 23,683,100 as of February 18, 2011.

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Documents Incorporated by Reference

Portions of Part II of this annual report on Form 10-K and Items 10, 11, 12, 13 and 14 of Part III of this annual report on Form 10-K incorporate information by reference from the registrant's definitive proxy statement filed pursuant to Regulation 14A in connection with the registrant's 2011 Annual Meeting of Stockholders or an amendment to this annual report on Form 10-K to be filed with the Securities and Exchange Commission within 120 days after the close of the fiscal year covered by this annual report on Form 10-K.

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KRATOS DEFENSE & SECURITY SOLUTIONS, INC.
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All references to "us," "we," "our," the "Company" and "Kratos" refer to Kratos Defense & Security Solutions, Inc., a Delaware Corporation, and its subsidiaries.

FORWARD-LOOKING STATEMENTS

This Annual Report on Form 10-K (this "Annual Report") contains "forward-looking statements" that involve risks and uncertainties, as well as assumptions that, if they never materialize or prove incorrect, could cause our results to differ materially and adversely from those expressed or implied by such forward-looking statements. These statements involve known and unknown risks, uncertainties and other important factors that may cause our actual results, performance or achievements to be materially different from any future results, performances or achievements expressed or implied by the forward looking statements. Forward looking statements may include, but are not limited to, statements relating to our future financial performance, the growth of the market for our services, expansion plans and opportunities and statements regarding our intended uses of the proceeds of the securities offered hereby. 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.

Forward looking statements reflect our current views about future events, are based on assumptions, and are subject to known and unknown risks and uncertainties. Many important factors could cause actual results or achievements to differ materially from any future results or achievements expressed in or implied by our forward looking statements, including the factors listed below. Many of the factors that will determine future events or achievements are beyond our ability to control or predict. Certain of these are important factors that could cause actual results or achievements to differ materially from the results or achievements reflected in our forward looking statements, including, but not limited to those specifically addressed in Item 1A. "Risk Factors" in this Annual Report, as well as those discussed elsewhere in this Annual Report.

These forward looking statements reflect our views and assumptions only as of the date such forward-looking statements are made. You should not place undue reliance on forward looking statements. Except as required by law, we assume no responsibility for updating any forward looking statements nor do we intend to do so. Our actual results, performance or achievements could differ materially from the results expressed in, or implied by, these forward looking.

PART I

Item 1. *Business*

Overview

We are a specialized national security business providing mission critical products, services and solutions for United States national security priorities. Our core capabilities are sophisticated engineering, manufacturing and system integration offerings for national security platforms and programs. Our principal services are related to, but are not limited to, Command, Control, Communications, Computing, Combat Systems, Intelligence, Surveillance and Reconnaissance ("C5ISR"); related cybersecurity; cyberwarfare; information assurance and situational awareness solutions; weapons systems lifecycle support and sustainment; military weapon range operations and technical services; missile, rocket and weapons system testing and evaluation; missile and rocket mission launch services, primarily for Ballistic Missile Defense; public safety, critical infrastructure security and surveillance systems; modeling and simulation; unmanned aerial vehicle systems ("UAVs"); and advanced network engineering and information technology services. We offer our customers products, solutions, services and expertise to support their mission-critical needs by leveraging our skills across our core offering areas.

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Our primary end customers are United States Federal Government agencies, including the Department of Defense ("DoD"), classified agencies, intelligence agencies, other National Security agencies and Homeland Security related agencies. We believe our stable client base, strong client relationships, broad array of contract vehicles, considerable employee base possessing national security clearances, extensive list of past performance qualifications, and significant management and operational capabilities position us for continued growth.

We provide products, solutions and services for a wide range of established, deployed and operating national security platforms, including, but not limited to: Aegis Ballistic Missile Defense systems, M1 Abrams tanks, Bradley fighting vehicles, F-5 Tiger, HiMARS, Chaparral and Hawk missile systems, Kiowa AH-60 helicopters, DDG-1000 Zumwalt destroyers, attack and missile submarines, certain intelligence surveillance and reconnaissance systems and various unmanned systems.

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 Select Market trading symbol to "KTOS".

We were incorporated in the state of New York on December 19, 1994 and began operations in March 1995. We reincorporated in the state of Delaware in 1998.

Current Reporting Segments

We operate in two principal business segments: Kratos Government Solutions and Public Safety and Security. 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 Annual Report are presented in a manner consistent with our operating structure. For additional information regarding our operating segments, see Note 14 of the Notes to the 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 KGS segment provides products, solutions and services primarily for mission critical National Security priorities. KGS customers primarily include National Security related agencies, the Department of Defense, intelligence agencies and classified agencies. Our work includes weapon systems sustainment, lifecycle support and extension; C5ISR services, including related cybersecurity, cyberwarfare, information assurance and situational awareness solutions; military range operations and technical services; missile, rocket, and weapons systems test and evaluation; mission launch services; modeling and simulation, UAV products and technology, and advanced network engineering and information technology services; and public safety, security and surveillance systems integration. We produce products, solutions and services related to certain C5ISR platforms, unmanned system platforms, weapons systems, national security related assets and warfighter systems.

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Public Safety and Security ("PSS") Segment

Our PSS segment provides independent integrated solutions for advanced homeland security, public safety, critical information, security and surveillance systems for government and commercial applications. Our solutions include designing, installing and servicing building technologies that protect people, critical infrastructure, assets, information and property and make facilities more secure and efficient. We provide solutions in such areas as the design, engineering and operation of command and control centers; the design, engineering, deployment and integration of access control; building automation and control; communications; digital and closed circuit television security and surveillance; fire and life safety; maintenance and services and product support services.

We provide solutions for customers in the critical infrastructure, power generation, power transport, nuclear energy, financial, information technology, healthcare, education, transportation and petro-chemical industries, as well as certain government and military customers. For example, we provide biometrics and other access control technologies to customers such as pipelines, electrical grids, municipal port authorities, power plants, communication centers, large data centers, government installations and other commercial enterprises.

Competitive Strengths

We believe we have robust capabilities and past performance qualifications in our respective business areas, including a work force that is experienced with the various programs we service and the customers we serve. Additionally, the majority of our employees have national security clearances specifically related to the customers they work for and the contracts which they work on. We believe the following key strengths distinguish us competitively:

- *Significant and highly specialized experience.* Through existing customer engagements and the government-focused acquisitions we have completed over the past several years, we have amassed significant and highly specialized experience in areas directly related to C5ISR weapon system life-cycle extension and sustainment; missile, rocket and weapons system testing and evaluation; military range operations and technical services, and other highly differentiated services and solutions. This collective experience, or past performance qualifications, is a requirement for the majority of our contract vehicles and customer engagements. Further enhancing our specialized expertise, a majority of our approximately 2,900 employees have national security clearances, including top secret and higher. We believe these characteristics represent a significant competitive strength and position us to win renewal or follow-on business.

- *Specialized national security focus aligned with mission-critical national security priorities.* Continued concerns related to the threat posed by certain foreign nations and terrorists have caused the U.S. Government to identify national security as an area of functional and spending priority. Budget pressures, particularly related to DoD spending, have placed a premium on developing and fielding relatively low-cost, high-technology solutions to assist in national security missions. Our primary capabilities and areas of focus, listed below, are strongly aligned with the objectives of the U.S. Government:

  - Intelligence, surveillance and reconnaissance
  - Command, control and combat systems
  - Unmanned systems
  - Ballistic missile defense
  - Cyber security and information assurance

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We believe our strategy has been confirmed through our established positions on 11 of the top 15 DoD programs in terms of total procurement and research, development, testing and evaluation spending, including the F-35 Lightning II, multiple missile defense programs, Bridge Combat Team, multiple unmanned aerial vehicle ("UAV") programs, Blackhawk helicopter and related variants, CVN-21 Carrier Replacement, DDG-51 Aegis Destroyer, Littoral Combat Ship and others.

Strategic geographic locations and base realignment and closure. The U.S. Base Realignment and Closure Act of 2005 ("BRAC") is the congressionally authorized process the DoD has implemented to reorganize its base structure to fewer, larger bases in order to support U.S. armed forces more efficiently and effectively, increase operational readiness and facilitate new ways of doing business. As a result of the DoD's BRAC transformation, we have concentrated part of our business strategy on building a significant presence in key BRAC receiving locations where the U.S. Federal Government is relocating its personnel and related technical and professional services. We believe our focus on increasing our strategic presence in key BRAC receiving locations will provide us with a significant competitive advantage.

Diverse base of key contracts with low concentration. As a result of our business development focus on securing key contracts, we are a preferred contractor on numerous multi-year, government-wide acquisition contracts ("GWACs") and multiple award contracts. Our preferred contractor status provides us with the opportunity to bid on hundreds of millions of dollars of business each year against a discrete number of other pre-qualified companies. We have a highly diverse base of contracts with no contract representing more than 5% of 2010 revenue. Our fixed-price contracts, almost all of which are production contracts, represent approximately 57% of our 2010 revenue. Our cost-plus-fee contracts and time and materials contracts represent approximately 22% and 21%, respectively, of our 2010 revenue. We believe our diverse base of key contracts and low reliance on any one contract provides us with a stable, balanced revenue stream.

In-depth understanding of client missions. We have a reputation for providing mission-critical services and solutions to our clients. Our relationships with our U.S. Army, U.S. Navy and U.S. Air Force customers generally exceed 10 years, enabling us to develop an in-depth understanding of their missions and technical needs. In addition, we have employees located at customer sites, providing us valuable strategic insights into our clients' ongoing and future program requirements. Our in-depth understanding of our clients' missions, in conjunction with the strategic location of our employees, enables us to offer technical solutions tailored to our clients' specific requirements and evolving mission objectives. In addition, once we are on-site with a customer, we have historically been successful in winning recompete business in the vast majority of cases.

Significant cash flow visibility driven by stable backlog. As of December 26, 2010, our total backlog was approximately $674 million, of which approximately $292 million was funded backlog. The majority of our sales are from orders issued under long-term contracts, typically three to five years in duration. Our contract backlog provides visibility into stable future revenue and cash flow over a diverse set of contracts.

Highly skilled employees and an experienced management team. We deliver our services through a skilled workforce of approximately 2,900 employees. Our senior managers have significant experience with U.S. Federal Government agencies, the U.S. military and federal government contractors. Members of our management team have experience growing businesses both organically and through acquisitions. We believe that the cumulative experience and differentiated expertise of our personnel in our core focus areas, coupled with our sizable employee base, the majority of which hold national security clearances, allows us to qualify for and bid on larger projects in a prime contracting role.

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Services and Solutions

We provide a range of integrated engineering, war fighter, security and information technology services, solutions, and products by leveraging our core service offerings: C5ISR weapons systems lifecycle sustainment, support, and extension; military range operations and technical services; missile and rocket test and evaluation; security systems integration; manufacturing of tactical combat vehicle shelters for C5ISR systems, weapon systems and warfighters; and learning, performance and training solutions.

C5ISR (Command, Control, Communications, Computing, Combat Systems, Intelligence, Surveillance and Reconnaissance)

In the area of C5ISR, we are involved in a wide range of services, including installation, upgrade and maintenance of command, control, computing, and surveillance systems for customers such as the Joint Inter Agency Task Force- south ("JIATF"), the Naval Undersea Warfare Center (NUWC) and the Space and Naval Warfare Systems Center (SPAWAR). We are also involved in the study, research and development of exotic sensors, including Electrical-Optical/Infrared ("EO/IR") sensors, for our customers.

Weapon Systems Lifecycle Sustainment, Support and Extension

We provide weapons systems life cycle sustainment, support, and extension services for the DoD and foreign governments. These services focus on maintaining, testing and repairing certain weapons systems for the war fighter.

Manufacturing of tactical combat vehicle shelters for C5ISR systems, unmanned aerial systems, weapon systems and warfighters

We provide tactical combat vehicle shelters for C5ISR systems, weapon systems and warfighters. Our tactical military facilities and products include lightweight, high-strength enclosures for widely recognized military programs and platforms, as well as ruggedized and readily transported enclosures. Many of our products include High Altitude Electromagnetic Pulse ("HEMP") protection, and other types of electromagnetic, electronic warfare and other protections. Our product design approach focuses on highly engineered enclosures and facilities that have the flexibility to be modified to customer specifications. We routinely design, integrate and install components into our standard products, such as command, control and communication systems infrastructure, racks and cabinets and power distribution and lighting, among others.

Missile and Rocket Test and Evaluation

We have expertise in the area of ballistic missile and rocket test and evaluation services, which are primarily dedicated to United States Ballistic Missile Defense (BMD) missions. This includes exclusive rights to the design and manufacture of the motor on the Oriole Rocket System and ancillary hardware for sounding rockets, suborbital research and target services together with both intellectual property and subject matter expertise in sensors and modeling and simulation associated with a wide range of missile technologies. Additionally, this area of our business develops and produces low-cost ballistic missile defense targets. These ballistic missile targets or AEGIS Readiness Assessment Vehicles (ARAVs) are a key element in U.S. AEGIS based Ballistic Missile Defense forces.

Security Systems Integration

We have broad experience integrating security services and solutions across a number of network and communications platforms. In particular, our non-federal business has extensive experience and has developed significant customer relationships by providing best-in-class systems integration services on a

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variety of platforms including digital (IP) surveillance and security, building automation systems and controls, fire and life safety systems, access control and perimeter protection, and service and maintenance of the aforementioned systems.

We have comprehensive experience providing engineering services at any phase of a project lifecycle including program management, engineering design, system engineering, operations and maintenance, integrated telecommunications, and warfare systems training.

We also develop and produce network management and protection proprietary products NeuralStar and dopplerVUE.

Missile Range Operations and Technical Services

A key area of differentiation for us is within the missile range and technical service areas. We have resources stationed at many major weapons and targets range locations throughout the United States, including Naval Air Warfare Center Pt. Mugu, Hawaii Pacific Missile Range, Fort Bliss, Texas, and White Sands Missile Range, New Mexico. Our services include aerial target operations and maintenance, surface target operations and maintenance, missile systems operations and maintenance, range operations planning and support, hazardous materials management, supply and logistics support, and manufacturing.

Learning, Performance and Training Solutions

Our learning, performance and training solutions consist of a broad range of products and service capabilities to deliver training solutions and web-enabled or satellite based interactive distance learning for customers in the DoD, other government agencies, universities and commercial organizations. Our training solutions include services, product development, and tools addressing a wide range of related disciplines that include human performance factors, job and task analysis, competencies definitions, skills and knowledge building via multiple delivery mediums, tracking, assessment, evaluation, and trend analysis. In addition, we develop and provide classroom based and e-learning training and education programs and Net-Centric Human Systems Integration (HSI) solutions.

We offer a range of IT services and solutions from conceptual network planning to system service and maintenance. We also offer our proprietary software based network management products via software license and maintenance sales which also serve as a platform for incremental network based services work. We have extensive experience building complex and secure networks for the federal government, and we possess in-depth experience with network operations centers. Our services include network operations centers, help desks, system maintenance, system upgrades, configuration management, data warehousing, commercial off the self ("COTS") selection and integration, and high performance computing.

Our Strategy

Our strategy is to aggressively grow our business as a leading provider of highly differentiated products, solutions and services in our core areas of focus as noted above by delivering comprehensive, high-end engineering services, technical solutions, product manufacturing, and information technology solutions to federal government agencies, while improving our margin rates and overall profitability. To achieve our objective, we intend to accelerate internal growth and pursue strategic acquisitions.

Accelerate Internal Growth

We are focused on accelerating our internal growth rate by capitalizing on our current contract base and customer relationships, expanding product, solution and service offerings provided to our

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existing clients, expanding our client and contract base, improving our operating margins, capitalizing on corporate infrastructure investments and concentrating on high value-added contracts.

Capitalize on Current Contract Base. We are pursuing new program and contract opportunities and awards, as we build the business, with our expanding customer base, contract portfolio, and product, solution and service offerings. We are aggressively pursuing task orders under existing contract vehicles to maximize our revenue and strengthen our client relationships, though there is no assurance that the federal government will make awards up to the ceiling amounts or that we will be awarded any task orders under these vehicles. We have developed several internal tools that facilitate our ability to track, prioritize and win task orders under these vehicles. Combining these tools with our technical expertise, our strong past performance record and our knowledge of our clients' needs, should position us to win additional task orders.

Expand Product, Solution and Service Offerings Provided to Existing Clients. We are focused on expanding the products, solutions and services we provide to our current clients by leveraging our strong relationships, technical capabilities and past performance record, and by offering a wider range of comprehensive solutions as we continue to acquire companies with new areas of specialization. In regard to new areas of specialization, two of our recent acquisitions have expanded our service offerings to include manufacturing of tactical combat vehicle shelters for C5ISR systems, unmanned systems, weapon systems and warfighters. We believe our understanding of client missions, processes and needs, in conjunction with our full lifecycle IT offerings, including cybersecurity, cyberwarfare and situational awareness, positions us to capture new work from existing clients as the federal government continues to increase the volume of IT services contracted to professional services providers. Moreover, we believe our strong past performance record positions us to expand the level of services we provide to our clients as the federal government places greater emphasis on past performance as a criterion for awarding contracts.

Expand Client and Contract Base. We are also focused on expanding our client base into areas with significant growth opportunities by leveraging our capabilities, industry reputation, long-term client relationships and diverse contract base. We anticipate that this expansion will enable us both to pursue additional higher value work and to further diversify our revenue base across the federal government. Our long-term relationships with federal government agencies, together with our GWAC vehicles, give us opportunities to win contracts with new clients within these agencies.

Improve Operating Margins. We believe that we have opportunities to increase our operating margins and improve profitability by capitalizing on our corporate infrastructure investments and internally developed tools, improving efficiencies and reducing costs, and concentrating our efforts on increasing the percentage of revenues generated from high value-added contracts.

Capitalize on Corporate Infrastructure Investments. In recent periods, we have made significant investments in our senior management and corporate infrastructure in anticipation of future revenue growth. These investments included hiring senior executives with significant experience in the national security business, strengthening our internal controls over financial reporting and accounting staff in support of public company reporting requirements, expanding our Sensitive Compartmented Information Facilities and other corporate facilities, and expanding our backlog and bid and proposal pipeline. We will be allocating additional resources in our pursuit of new and larger contract opportunities, leveraging our increased scale and robust past performance qualifications. We believe our management experience and corporate infrastructure are more typical of a company with a much larger revenue base than ours. We therefore anticipate that, to the extent our revenue grows, we will be able to leverage this infrastructure base and increase our operating margins.

Concentrate on High Value-Added Contracts. We expect to improve our operating margins as we strive to increase the percentage of revenue we derive from our work as a contractor and from engagements where contracts are awarded on a best value, rather than on a low cost, basis. The federal government's move toward performance-based contract awards to realize greater return on its investment has resulted in a shift to greater utilization of best value awards. We believe this shift will enable us to expand our operating margins as we are awarded more contracts of this nature.

Pursuit of Strategic Acquisitions

We intend to supplement our organic growth by identifying, acquiring and integrating businesses that meet our primary objective of providing us with enhanced capabilities to pursue a broader cross section of the DoD, Department of Homeland Security ("DHS") and other government markets, complement and broaden our existing client base and expand our primary service offerings. Our senior management team has significant acquisition experience.

Pending Acquisition of Herley Industries, Inc.

On February 7, 2011, we entered into an Agreement and Plan of Merger (the "Merger Agreement") with Lanza Acquisition Co., our indirect wholly-owned subsidiary ("Merger Sub"), and Herley Industries, Inc. ("Herley"). Pursuant to the terms of the Merger Agreement we will acquire Herley through a tender offer by Merger Sub for all of Herley's outstanding common stock and a subsequent merger between Merger Sub and Herley (the "Merger"). Herley is a leading provider of microwave technologies for use in command and control systems, flight instrumentation, weapons sensors, radar, communication systems, and electronic warfare systems. Herley has served the defense industry since 1965 by designing and manufacturing microwave devices for use in high-technology defense electronics applications. Herley's products represent key components in the national security efforts of the U.S., as they are employed in mission-critical electronic warfare, electronic attack, electronic warfare threat and radar simulation, command and control network, and cyber warfare/cybersecurity applications.

The boards of directors of Kratos and Herley have approved the Merger Agreement and the transactions contemplated thereby. On February 25, 2011, pursuant to the terms of the Merger Agreement, Merger Sub commenced a tender offer (the "Offer") to purchase all of Herley's issued and outstanding shares of common stock, par value $0.10 per share (the "Herley Common Stock"), at a price of $19.00 per share in cash, without any interest thereon (the "Offer Price"). The Offer will remain open for 20 business days, subject to periods of extension through June 30, 2011 if the conditions to the Offer have not been satisfied at the end of any Offer period (subject to the parties' termination rights under the Merger Agreement).

Acquisition in the PSS segment

On December 15, 2010, we acquired Henry Bros. Electronics, Inc. ("HBE") in a cash merger for a purchase price of $56.6 million, of which $54.9 million was paid in cash and $1.7 million reflects the fair value of options to purchase common stock of HBE that were assumed by us and converted into options to purchase our common stock upon completion of the merger. HBE is a leading provider of homeland security solutions, products, and system integration services, including the design, engineering and operation of command and control systems for the protection of strategic assets and critical infrastructure in the U.S. HBE also has particular expertise in the design, engineering, deployment and operation of specialized surveillance, thermal imaging, analytics, radar, and biometrics technology based security systems. Representative HBE programs and customers include DoD agencies, nuclear power generation facilities, state government and municipality related agencies, major national airports, major harbors, railways, tunnel systems, energy centers, power plants, and related infrastructure.

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Acquisitions in the KGS segment

On December 7, 2010, we acquired Southside Container & Trailer, LLC ("Southside" or "SCT") for $13.7 million of which $12.2 million in cash was paid at closing, $0.3 million is being held as security for SCT's indemnification obligations as set forth in the Purchase Agreement and approximately $1.2 million of which represents the acquisition date fair value of additional performance based consideration. The potential undiscounted amount of all future contingent consideration that may be payable by us under the Purchase Agreement is $3.5 million. Southside was a privately-held, premier provider of National Security related Command and Control Center, Law Enforcement, Military Aviation and Data Center Products, Shelters and Solutions for the United States Department of Defense, National Security agencies and related customers. Southside provides products and solutions for specialized war fighter and critical asymmetric warfare related missions. Representative end customers and program locations include the United States Army, Marine Corps, Special Operations Command, SPAWAR, Fort Bragg, Fort Lewis, Fort Bliss, Fort McGregor, Fort Irwin, Fort Stewart, the Border Patrol and the National Guard.

On August 9, 2010, we acquired DEI Services Corporation ("DEI") in a cash merger valued at approximately $14.0 million, of which $9.0 million was paid in cash at closing and $5.0 million of which represented the acquisition date fair value of additional performance-based consideration, of which $0.4 million was achieved and paid in September 2010. Pursuant to the terms of that the applicable agreement and plan of merger (the "DEI Agreement"), upon achievement of certain cash receipts, revenue, EBITDA and backlog amounts in 2010, 2011 and 2012, we will be obligated pay certain additional contingent consideration. The potential undiscounted amount of all future contingent consideration that may be payable by us under the DEI Agreement is between zero and $12.3 million. DEI designs, manufactures and markets full-scale training simulation products. In addition to the engineering and construction of physical simulators for air and ground military vehicles, DEI provides instructional design, courseware creation, learning application programming and other supporting services. Among DEI's most successful products are training and simulation solutions for fixed-wing aircraft (including the Tiger, Harrier and Prowler aircraft), rotor-wing aircraft (including Blackhawk, Chinook and Sea Stallion helicopters) and ground combat vehicles including the M1 Abrams Main Battle Tank and M2 Bradley Fighting Vehicle.

On May 19, 2010, we acquired Gichner Holdings, Inc. ("Gichner") in a cash for stock transaction valued at approximately $133.0 million. Gichner has manufacturing and operating facilities in Dallastown and York, Pennsylvania and Charleston, South Carolina, and is a manufacturer of tactical military products, combat support facilities, subsystems, modular systems and shelters primarily for the DoD and leading defense system providers. Representative programs for which Gichner provides products and solutions include the MQ 1C Sky Warrior, Gorgon Stare, MQ 8B Fire Scout and RQ-7 Shadow Unmanned Aerial Vehicles, the Command Post Platform and Joint Light Tactical Vehicles, Combat Tactical Vehicles, DDG-1000 Modular C5 Compartments and the Persistent Threat Detection System ISR Platform.

On December 24, 2008, we acquired DFI in a stock for stock transaction valued at approximately $37.0 million. DFI provides Command, Control, Communications, Computing, Intelligence, Surveillance, and Reconnaissance ("C4ISR") and technical engineering services, UAV products and technology and has significant engineering, modeling and simulation capabilities. The acquisition of DFI has provided 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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On June 28, 2008, we acquired SYS Technologies ("SYS") for a purchase price of $55.9 million, including direct transaction costs of $2.4 million and estimated restructuring costs of $2.6 million to be paid by us. SYS provided a range of C4ISR and net-centric solutions to federal, state, and local governments as well as other customers. The combination of SYS and Kratos created a broad, complementary set of offerings, and positioned 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.

Customers

A representative list of our customers in our KGS segment during 2010 included the U.S. Air Force, U.S. Army, U.S. Navy, Missile Defense Agency, the Department of Homeland Security, NASA, Foreign Military Sales ("FMS"), the U.S. Southern Command, and U.S. Intel Community. In 2010, our customers in the PSS segment included Halliburton, Hess Corporation, Houston Community College, Texas A&M University, AT&T, Chevron, Mellon Bank, Calpine Power Plants, Capital Health, DuPont Fabros, Colonial Pipeline, BP America, The Houston Ballet, University of Houston, Meridian Health and Memorial Hermann Hospital System.

Revenue from the U.S. Government (which includes Foreign Military Sales) includes revenue from contracts for which we are the prime contractor as well as those for which we are a subcontractor and the ultimate customer is the U.S. Government. Revenues from U.S. Government agency customers in aggregate accounted for approximately 79%, 86% and 87% of total revenues in 2008, 2009, and 2010, respectively.

Backlog

As of December 26, 2010 and December 27, 2009, our total backlog was approximately $674 million and $565 million, respectively, of which $292 million was funded as of December 26, 2010 and $124 million was funded as of December 27, 2009. 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 GWACs 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 contracts, based on our experience under such contracts and similar contracts. Unfunded backlog also includes priced options, which consist of the aggregate contract revenues expected to be earned as a result of a customer exercising an option period that has been specifically defined in the original contract award.

Contracts undertaken by us may extend beyond one year. Accordingly, portions are carried forward from one year to the next as part of backlog. Because many factors affect the scheduling of projects, no assurance can be given as to when revenue will be realized on projects included in our backlog. Although funded backlog represents only business that is considered to be firm, we cannot guarantee that cancellations or scope adjustments will not occur. The majority of funded backlog represents contracts 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 U.S. government contracts included in backlog, whether or not funded, may be terminated at the convenience of the U.S. government.

Employees

As of December 26, 2010, including the employees from the Southside and HBE acquisitions, we had a work force of approximately 2,900 full-time, part-time and on-call employees, the majority of which hold an active National Security clearance. We have one collective bargaining unit of approximately 22 employees which is represented by the International Association of Machinists & Aerospace Workers, AFL-CIO, White Sands Local Lodge 2515, Alamogordo, New Mexico.

Competition

Our market is competitive and includes the full range of federal and non-federal engineering and IT service providers. Many of the companies that we compete against have significantly greater financial, technical and marketing resources, and generate greater revenues than we do. Competition in the federal business segment includes tier one, large federal government contractors, such as Northrop Grumman, Lockheed Martin, General Dynamics, SAIC, ITT Systems, Computer Sciences Corporation, ARINC, Raytheon, BAE Systems, and CACI. While we view government contractors as competitors, we often team with these companies in joint proposals or in the delivery of our services for customers. Tier two competitors include smaller and mid-tier government contractors such as NCI, Inc., VSE Corporation, Global Defense Technology & Systems, Inc., and Dynamics Research Corp. Competition in the PSS segment includes Siemens Building Technology, Johnson Controls, Ingersoll Rand, and Convergint.

We believe that the principal competitive factors in our ability to win new business include past performance qualifications, domain and technology expertise, the ability to replace contract vehicles, the ability to deliver results within budget (time and cost), reputation, accountability, staffing flexibility including the large number of personnel with government security clearances, and project management expertise. We believe our ability to compete also depends on a number of additional factors including the ability of our customers to perform the services themselves and competitive pricing for similar services.

Available Information

We file reports with the Securities and Exchange Commission ("SEC"). We make available on our website under "Investor Relations/SEC Filings," free of charge, our annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to those reports as soon as reasonably practicable after we electronically file such materials with or furnish them to the SEC. Our website address is *www.kratosdefense.com*.

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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 Annual 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 Annual Report, including our consolidated financial statements and related notes.

Risks Related to the Proposed Acquisition of Herley

The proposed acquisition of Herley may not be completed within the expected timeframe, or at all, and the failure to complete such acquisition could adversely affect our stock price and our future business and financial results.

On February 7, 2011, we entered into the Merger Agreement with Herley. The Merger Agreement is an executory contract subject to numerous closing conditions beyond our control, and there is no guarantee that these conditions will be satisfied in a timely manner or at all. If any of the conditions to the proposed Merger are not satisfied (or waived by the other party), we may not complete the Merger or realize the anticipated benefits thereof. Disputes regarding interpretations of the Merger Agreement could also delay or prevent the closing. In addition, the market price of our common stock may reflect various market assumptions as to whether and when the proposed Merger will occur. Consequently, the failure to complete the Merger within the expected timeframe, or at all, could result in a significant change in the market price of our common stock.

We may experience difficulties in integrating Herley's business and realizing the expected benefits of the proposed Merger.

Our ability to achieve the benefits we anticipate from the proposed Merger will depend in large part upon whether we are able to integrate Herley's business into our business in an efficient and effective manner. Because the businesses of Herley and Kratos differ, we may not be able to integrate Herley's business smoothly or successfully and the process may take longer than expected. The integration of certain operations, including Herley's international operations, and the differences in operational culture following the Merger will require the dedication of significant management resources, which may distract management's attention from day-to-day business operations. If we are unable to successfully integrate the operations of Herley's business into our business, we may be unable to realize the revenue growth, synergies and other anticipated benefits we expect to achieve as a result of the proposed Merger and our business and results of operations could be adversely affected.

The announcement and pendency of the proposed Merger may cause disruptions in Herley's business, which could have an adverse effect on our business, financial condition or results of operations following completion of the Merger.

The announcement and pendency of the proposed Merger could cause disruptions in the business of Herley. Specifically:

- current and prospective employees of Herley may experience uncertainty about their future roles with Kratos, which might adversely affect the ability of Herley to retain key personnel and attract new personnel;

- current and prospective customers of Herley may experience uncertainty about the ability of Herley to meet their needs, which might cause customers to seek other suppliers for the products and services provided by Herley; and

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- management's attention may be focused on the Merger, which may divert management's attention from the core business of Herley and other opportunities that could have been beneficial to Herley.

This could have an adverse effect on the business, financial condition or results of operations of Herley prior to the completion of the Merger and on us following the completion of the Merger. These disruptions to Herley's business could be exacerbated by a delay in the completion of the Merger.

Herley may have liabilities that are not known, probable or estimable at this time.

As a result of the Merger, Herley will become our subsidiary and we will effectively assume all of its liabilities, whether or not asserted. There could be unasserted claims or assessments that we failed or were unable to discover or identify in the course of performing due diligence investigations of Herley. In addition, there may be liabilities that are neither probable nor estimable at this time which may become probable and estimable in the future. Any such liabilities, individually or in the aggregate, could have a material adverse effect on our business. We may learn additional information about Herley that adversely affects us, such as unknown, unasserted or contingent liabilities and issues relating to compliance with applicable laws.

The Merger may not be accretive and may cause dilution to the combined company's earnings per share, which may negatively impact the price of the common stock of the combined company following the completion of the Merger.

We currently anticipate that the Merger will be accretive to the earnings per share ("EPS") of the combined company during the first full calendar year after the Merger is completed. This expectation is based on preliminary estimates and estimated purchase price valuations of amortizable purchased intangibles and assumes certain synergies expected to be realized by the combined company during such time, including the elimination of Herley's expenses related to operating as a publicly traded company and excluding the impact of merger related expenses. Such estimates and assumptions could materially change due to any changes in the final purchase price valuation of amortizable purchased intangibles, the failure to realize any or all of the benefits expected in the Merger or other factors beyond our control or the control of Herley. All of these factors could delay, decrease or eliminate the expected accretive effect of the Merger and cause resulting dilution to the combined company's EPS or to the price of the common stock of the combined company.

Risks Related to Our Business Currently and Following the Proposed Acquisition of Herley

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. Current projections of the DoD indicate that government spending is expected to decrease beginning in 2011. Any such reductions or other government budgetary constraints and any changes in government contracting policies 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;

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- 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;
- increases in the federal government initiatives related to in-sourcing;
- 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.

The entire federal government is currently operating under a Continuing Resolution authority for fiscal year ending September 30, 2011. The Continuing Resolution funds programs and services, including DoD budgets, at approximately the same levels as fiscal year 2010. The Continuing Resolution expires on March 4, 2011, after which, Congress will either pass a new appropriations bill, extend the Continuing Resolution, or shut down the government for all nonessential federal government services. An extension of the Continuing Resolution or a shut down of the government for all nonessential federal government services may adversely affect our sales, operating results and operating cash flows and possibly delay new awards.

We significantly increased our leverage in connection with the financing of recent acquisitions.

We incurred approximately $225 million of indebtedness in the form of 10% Senior Secured Notes (the "Original Notes") in connection with the financing of our acquisition of Gichner. On August 11, 2010, we completed an exchange offer for the Original Notes pursuant to a registration rights agreement entered into in connection with the issuance of the Original Notes (such exchanged notes, the "Exchange Notes"). As a result of this indebtedness, our interest payment obligations have increased. The degree to which we are leveraged could have adverse effects on our business, including the following:

- it may make it difficult for us to satisfy our obligations under the Exchange Notes, and our other indebtedness and contractual and commercial commitments;
- it may require us to dedicate a substantial portion of our cash flow from operations to payments on our indebtedness, thereby reducing the availability of our cash flow to fund working capital, capital expenditures and other general corporate purposes;
- it may limit our flexibility in planning for, or reacting to, changes in our business and the industries in which we operate;
- it may restrict us from making strategic acquisitions or exploiting business opportunities;
- it may place us at a competitive disadvantage compared to our competitors that have less debt;

it may limit our ability to borrow additional funds;

- it may prevent us from raising the funds necessary to repurchase the Exchange Notes tendered to us if there is a change of control, which would constitute a default under the indentures governing the Exchange Notes and under our credit facility; and

- it may decrease our ability to compete effectively or operate successfully under adverse economic and industry conditions.

If new debt is incurred, in connection with our proposed acquisition of Herley or otherwise, these risks may intensify. Our ability to meet our debt service obligations will depend upon our future performance, which may be subject to the financial, business and other factors affecting our operations, many of which are beyond our control.

Our credit facility contains restrictive covenants that could limit our ability to operate our business and, if not satisfied, could result in the acceleration of any amounts then due under the credit facility.

The agreement governing our credit facility subjects us to various financial and other covenants with which we must comply. These covenants require that we maintain a minimum fixed charge coverage ratio and include restrictions on our ability 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 and effect certain acquisitions;

- sell assets;

- issue or become liable on a guarantee;

- create or acquire new subsidiaries; and

- effect a merger or consolidation, or sell all or substantially all of our assets.

Upon the occurrence of any event of default under our credit facility, our lenders could elect to declare all amounts then outstanding on our credit facility, together with accrued interest, to be immediately due and payable. If our lenders were to accelerate payment of these amounts, we may not have sufficient assets to repay them in full. In addition, if we fail to comply with these financial and other covenants, or are otherwise 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 deny future access to liquidity, seize control of substantially all of our assets and exercise other remedies provided for in those agreements and under applicable law.

We may need additional capital to fund the growth of our business, and financing may not be available on favorable terms or at all.

We currently anticipate that our available capital resources, including our credit facility and operating cash flow, 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. If we determine that it is necessary to raise additional funds, either through an expansion or refinancing of our credit facility or through public or private debt or equity financings, additional financing may not be available on terms favorable to us, or at all. Disruptions in the capital and credit markets may continue indefinitely or intensify, which could adversely affect our ability to access these markets. Limitations on our borrowing base contained in our credit facility may limit our access to capital, and 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. Our lenders may not agree to extend additional or continuing credit under our credit facility or waive restrictions on our access to capital. If we were to conduct a public or private offering of securities, any new offering would be likely to dilute our stockholders' equity ownership. 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 and our business, operating results or financial condition could be materially adversely affected.

Our ability to utilize our net operating loss carryforwards and certain other tax attributes may be limited.

Federal and state income tax laws impose restrictions on the utilization of net operating loss ("NOL") and tax credit carryforwards in the event that an "ownership change" occurs for tax purposes, as defined by Section 382 of the Internal Revenue Code of 1986, as amended. In general, an ownership change occurs when shareholders owning 5% or more of a "loss corporation" (a corporation entitled to use NOL or other loss carryovers) have increased their ownership of stock in such corporation by more than 50 percentage points during any 3-year period. The annual base Section 382 limitation is calculated by multiplying the loss corporation's value at the time of the ownership change by the greater of the long-term tax-exempt rate determined by the Internal Revenue Service in the month of the ownership change or the two preceding months. In March 2010, an "ownership change" occurred which will limit the utilization of the loss carryforwards. As a result, our annual utilization of NOL carryforwards will be limited to $28.1 million for five years and $11.6 million per year thereafter. For the fiscal year ended December 26, 2010, there was no impact of such limitations on the income tax provision since the amount of taxable income did not exceed the annual limitation amount. In addition, future equity offerings or acquisitions that have equity as a component of the purchase price could also result in an "ownership change". If and when any other "ownership change" occurs, utilization of the NOL or other tax attributes may be further limited.

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 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

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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 December 26, 2010 and December 27, 2009, our total backlog was approximately $674 million and $565 million, respectively of which $292 million was funded as of December 26, 2010 and $124 million was funded as of December 27, 2009. 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 $382 million of our total backlog as of December 26, 2010 is unfunded. 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. Unfunded backlog does not include estimates of revenue from GWAC 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 indefinite delivery, indefinite quantity 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 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.

During 2010, we acquired four companies. On May 19, 2010, we acquired Gichner. On August 9, 2010, we acquired DEI. On December 7, 2010, we acquired Southside. On December 15, 2010, we acquired HBE. On February 7, 2011, we entered into the Merger Agreement to acquire Herley.

We continually evaluate opportunities to acquire new businesses as part of our ongoing strategy and we may in the future acquire additional businesses that we believe could complement or expand our business or increase our customer base. Integrating the operations of acquired businesses successfully or otherwise realizing any of the anticipated benefits of acquisitions, including anticipated cost savings and additional revenue opportunities, involves a number of potential challenges. The failure to meet these integration challenges could seriously harm our financial condition and results of operations. Realizing the benefits of acquisitions depends in part on the integration of IT operations and personnel. These integration activities are complex and time-consuming and we may encounter unexpected difficulties or incur unexpected costs, including:

- our inability to achieve the operating synergies anticipated in the acquisitions;
- diversion of management attention from ongoing business concerns to integration matters;
- difficulties in consolidating and rationalizing IT platforms and administrative infrastructures;
- complexities associated with managing the geographic separation of the combined businesses and consolidating multiple physical locations where management may determine consolidation is desirable;

difficulties in integrating personnel from different corporate cultures while maintaining focus on providing consistent, high quality customer service;

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- difficulties or delays in transitioning federal government contracts pursuant to federal acquisition regulations;
- challenges in demonstrating to customers of Kratos and to customers of acquired businesses that the acquisition will not result in adverse changes in customer service standards or business focus;
- possible cash flow interruption or loss of revenue as a result of change of ownership transitional matters; and
- inability to generate sufficient revenue to offset acquisition costs.

Acquired businesses 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 impairment 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. Acquisitions and/or the related equity financings could also impact our ability to utilize our NOL carryforwards. 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. Acquisitions frequently involve benefits related to integration of operations. The failure to successfully integrate the operations or otherwise to realize any of the anticipated benefits of the acquisition could seriously harm our results of operations.

If we are unable to manage our growth, our business and financial results could suffer.

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.

Additionally, our future financial results depend in part on our ability to profitably manage our growth on a combined basis with the businesses we acquire. Management will need to maintain existing customers and attract new customers, recruit, retain and effectively manage employees, as well as expand operations and integrate customer support and financial control systems. If the integration-related expenses and capital expenditure requirements are greater than anticipated or if we are unable to manage our growth profitably after business acquisitions, our financial condition and results of operations may suffer.

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 are terminated or expire and are not renewed.

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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 U.S. 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 the federal fiscal year or the first quarter of the subsequent year. The U.S. 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 U.S. 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.

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, 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 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.

We depend on U.S. Government agencies as our primary customer and if our reputation or relationships with these agencies were harmed, our future revenues and growth prospects would be adversely affected.

In fiscal 2008, 2009 and 2010, we generated 79%, 86% and 87%, respectively, of our total revenues from contracts with the U.S. Government (including all branches of the U.S. military), either as a prime contractor or a subcontractor. We generated more than 10% of our total revenues during the last three fiscal years from each of the U.S. Army and U.S. Navy. We expect to continue to derive most of our revenues from work performed under U.S. Government contracts. Our reputation and relationship with the U.S. Government, and in particular with the agencies of the DoD and the U.S. intelligence community, are key factors in maintaining and growing these revenues. Negative press reports regarding conflicts of interest, poor contract performance, employee misconduct, information security breaches or other aspects of our business, regardless of accuracy, could harm our reputation, particularly with these agencies. If our reputation is negatively affected, or if we are suspended or debarred (or proposed for suspension or debarment) from contracting with government agencies for any reason, the amount of business with the U.S. Government would decrease and our future revenues and growth prospects would be adversely affected.

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 25% and 52%, respectively, of our federal business revenues for the year ended December 26, 2010. 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 vehicles. 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.

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.

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 as subcontractors to perform work we are obligated to perform for our clients. 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 contracts and administrative processes and systems are subject to audits and cost adjustments by the federal government, which could reduce our revenue, disrupt our business or otherwise adversely affect our results of operations.

Federal government agencies, including the Defense Contract Audit Agency ("DCAA"), routinely audit and investigate government contracts and government contractors' administrative processes and systems. These agencies review our performance on contracts, pricing practices, cost structure and compliance with applicable laws, regulations and standards. They also review the adequacy of our compliance with government standards for our accounting and management of internal control systems, including: control environment and overall accounting system, general information technology system, budget and planning system, purchasing system, material management and accounting system, compensation system, labor system, indirect and other direct costs system, billing system and estimating system used for pricing on government contracts. Both contractors and the U.S. Government agencies conducting these audits and reviews have come under increased scrutiny. The current audits and reviews have become more rigorous and the standards to which contractors are being held are being more strictly interpreted, increasing the likelihood of an audit or review resulting in an adverse outcome.

While we have submitted all applicable incurred cost claims, the actual indirect cost audits by the DCAA have not been completed for fiscal 2005 and subsequent fiscal years. Although we have

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recorded contract revenues subsequent to fiscal 2004 based upon costs that we believe will be approved upon final audit or review, we do not know the outcome of any ongoing or future audits or reviews and, if future adjustments exceed our estimates, our profitability would be adversely affected.

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. Our role as a contractor to agencies and departments of the U.S. Government results in our being routinely subject to investigations and reviews relating to compliance with various laws and regulations, including those associated with organizational conflicts of interest. These investigations may be conducted without our knowledge. Adverse findings in these investigations or reviews can lead to criminal, civil or administrative proceedings and we could face 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.

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 ensure 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.

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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.

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.

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.

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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 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.

Substantially all of the technology that is developed by us is developed under contract for our DoD customers. Accordingly, such intellectual property and rights to technology development are owned by the U.S. Government. Very few of our contracts involve the use of intellectual property rights, patents or trademarks owned by use. For the fiscal year ended December 26, 2010, these contracts accounted for less than 3% of our consolidated revenues.

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 26, 2010. 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.

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 *Financial Accounting Standards Board ("FASB") Accounting Standards Code ("ASC") Topic 350 Intangibles Goodwill and Other ("Topic 350")* 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. In the beginning of 2009, we performed another impairment test for goodwill in accordance with *Topic 350* 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 that segment 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 our average stock price as of February 28, 2009, compared with the test performed as of December 28, 2008. Future reviews could result in further impairment charges, which could have a significant effect on our financial results.

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

Any increase in our debt service obligations, including in connection with our proposed acquisition of Herley, may adversely affect our cash flow.

We expect our cash requirements in connection with our proposed acquisition of Herley to be approximately $316 million. On a pro forma basis, after giving effect to our acquisition of HBE on December 15, 2010 and our proposed acquisition of Herley, we would have had total long term debt of $452 million as of December 26, 2010, which includes $61 million raised in our recent public offering of shares of our common stock in February 2011 and $225 million of new indebtedness to fund the proposed acquisition of Herley. We currently intend to raise up to $325 million through debt financing in order to fund the proposed acquisition of Herley, with any excess used for other general corporate purposes. A higher level of indebtedness increases the risk that we may default on our debt obligations. We may not be able to generate sufficient cash flow to pay the interest on our debt, and future working capital, borrowings or equity financing may not be available to pay or refinance such debt. If we are unable to generate sufficient cash flow to pay the interest on our debt, we may have to delay or curtail our operations.

Our ability to generate cash flow from operations and to make scheduled payments on our indebtedness will depend on our future financial performance. Our future financial performance will be affected by a range of economic, competitive and business factors that we cannot control. A significant reduction in operating cash flow resulting from changes in economic conditions, increased competition or other events beyond our control could increase the need for additional or alternative sources of liquidity and could have a material adverse effect on our business, financial condition, results of operations, prospects and our ability to service our debt and other obligations. If we are unable to service our indebtedness, we will be forced to adopt an alternative strategy that may include actions such as reducing capital expenditures, selling assets, restructuring or refinancing our indebtedness or seeking additional equity capital. We cannot assure that any of these alternative strategies could be effected on satisfactory terms, if at all, or that they would yield sufficient funds to make required payments on our indebtedness.

If for any reason we are unable to meet our debt service and repayment obligations, we would be in default under the terms of the agreements governing our debt, which would allow our creditors at that time to declare certain outstanding indebtedness to be due and payable, which would in turn trigger cross-acceleration or cross-default rights between the relevant agreements. In addition, our lenders could compel us to apply all of our available cash to repay our borrowings or they could prevent us from making payments on our indebtedness. If the amounts outstanding under any outstanding indebtedness were to be accelerated, we cannot assure that our assets would be sufficient to repay in full the money owed to the lenders or to our other debt holders.

Some of our contracts with the U.S. Government are classified which may limit investor insight into portions of our business.

We derive a portion of our revenues from programs with the U.S. Government that are subject to security restrictions (classified programs), which preclude the dissemination of information that is classified for national security purposes. We are limited in our ability to provide details about these classified programs, their risks or any disputes or claims relating to such programs. As a result, you might have less insight into our classified programs than our other businesses and therefore less ability to fully evaluate the risks related to our classified business.

We are subject to environmental laws and potential exposure to environmental liabilities. This may affect our ability to develop, sell or rent our property or to borrow money where such property is required to be used as collateral.

As a result of the acquisition of Gichner, we use hazardous materials common to the industry in which Gichner operates. We are required to follow federal, state and local environmental laws and regulations regarding the handling, storage and disposal of these materials, including the Clean Air Act, the Clean Water Act, the Resource Conservation and Recovery Act, the Comprehensive Environmental Response, Compensation and Liability Act ("CERCLA"), and the Toxic Substances Control Act. We could be subject to fines, suspensions of production, alteration of our manufacturing processes or interruption or cessation of our operations if we fail to comply with present or future laws or regulations related to the use, storage, handling, discharge or disposal of toxic, volatile or otherwise hazardous chemicals used in our manufacturing processes. These regulations could require us to acquire expensive remediation equipment or to incur significant other expenses to comply with environmental regulations. Our failure to control the handling, use, storage or disposal of, or adequately restrict the discharge of, hazardous substances could subject us to liabilities and production delays, which could cause us to miss our customers' delivery schedules, thereby reducing our sales for a given period. We may also have to pay regulatory fines, penalties or other costs (including remediation costs), which could materially reduce our profits and adversely affect our financial condition. Permits are required for our operations, and these permits are subject to renewal, modification and, in some cases, revocation.

In addition, under environmental laws, ordinances or regulations, a current or previous owner or operator of property may be liable for the costs of removal or remediation of some kinds of petroleum products or other hazardous substances on, under, or in its property, adjacent or nearby property, or offsite disposal locations, without regard to whether the owner or operator knew of, or caused, the presence of the contaminants, and regardless of whether the practices that resulted in the contamination were legal at the time they occurred. We have incurred, and may incur in the future, liabilities under CERCLA and other environmental cleanup laws at our current or former facilities, adjacent or nearby properties or offsite disposal locations. The costs associated with future cleanup activities that we may be required to conduct or finance may be material. The presence of, or failure to remediate properly, petroleum products or other hazardous substances may adversely affect the ability to sell or rent the property or to borrow funds using the property as collateral. Additionally, we may become subject to claims by third parties based on damages, including personal injury and property damage, and costs resulting from the disposal or release of hazardous substances into the environment.

Litigation may distract us from operating our business.

Litigation that may be brought by or against us could cause us to incur significant expenditures and distract our management from the operation of our business. Furthermore, there can be no assurance that we would prevail in such litigation or resolve such litigation on terms favorable to us, which may adversely affect our financial results and operations.

Risks Related to Owning Our Stock

Our stock price may be volatile, and your investment in our stock could suffer a decline in value.

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. These broad market fluctuations may negatively affect the market price of our common stock. From December 27, 2009 to December 26, 2010, our closing stock price ranged from $9.46 to $14.93. You may not be able to resell your shares at or above the price you paid for them due to fluctuations in the market price of our common stock.

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 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.

These and other external factors may cause the market price and demand for our common stock to fluctuate substantially, which may limit or prevent investors from readily selling their shares of common stock and may otherwise negatively affect the liquidity of our common stock. Volatility in the market price of our common stock could also subject us to 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;
- 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;

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- 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

- agreements with a number of our executives 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.

Enacted and proposed changes in securities laws and regulations have increased our costs and may continue to increase our costs in the future.

In recent years, there have been several changes in laws, rules, regulations and standards relating to corporate governance and public disclosure, including the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley") and various other new regulations promulgated by the SEC and rules promulgated by the national securities exchanges.

The Dodd-Frank Act, enacted in July 2010, expands federal regulation of corporate governance matters and imposes requirements on publicly-held companies, including us, to, among other things, provide stockholders with a periodic advisory vote on executive compensation and also adds compensation committee reforms and enhanced pay-for-performance disclosures. While some provisions of the Dodd-Frank Act are effective upon enactment, others will be implemented upon the SEC's adoption of related rules and regulations. The scope and timing of the adoption of such rules and regulations is uncertain and accordingly, the cost of compliance with the Dodd-Frank Act is also uncertain.

Sarbanes-Oxley Act required changes in some of our corporate governance and securities disclosure and compliance practices. Under Sarbanes-Oxley, publicly-held companies, including us, are required to, among other things, furnish independent annual audit reports regarding the existence and reliability of their internal control over financial reporting and have their chief executive officer and chief financial officer certify as to the accuracy and completeness of their financial reports.

These and other new or changed laws, rules, regulations and standards are, or will be, subject to varying interpretations in many cases due to their lack of specificity. As a result, their application in practice may evolve over time as new guidance is provided by regulatory and governing bodies, which could result in continuing uncertainty regarding compliance matters and higher costs necessitated by ongoing revisions to disclosure and governance practices. Our efforts to comply with evolving laws, regulations and standards are likely to continue to result in increased general and administrative expenses and a diversion of management time and attention from revenue-generating activities to compliance activities. Further, compliance with new and existing laws, rules, regulations and standards may make it more difficult and expensive for us to maintain director and officer liability insurance, and we may be required to accept reduced coverage or incur substantially higher costs to obtain coverage. Members of our board of directors and our principal executive officer and principal financial officer could face an increased risk of personal liability in connection with the performance of their duties. As a result, we may have difficulty attracting and retaining qualified directors and executive officers, which could harm our business. We continually evaluate and monitor regulatory developments and cannot estimate the timing or magnitude of additional costs we may incur as a result.

Item 1B. *Unresolved Staff Comments.*

None.

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Item 2. ***Properties.***

Our principal executive offices for all business segments are located in approximately 34,000 square feet of office space in San Diego, California. The lease for such space expires on September 30, 2018.

KGS segment corporate resource offices which are owned in fee simple are located in the following locations: Dallastown, Pennsylvania, Charleston, South Carolina, and Walterboro, South Carolina; other leased KGS corporate resource offices are located in Washington, D.C.; Marietta, Georgia; Dayton, Ohio; Huntsville, Alabama; Alexandria, Virginia; York, Pennsylvania; Orlando, Florida; and Indianapolis, Indiana. Our PSS segment corporate resource offices, both of which are leased, are located in Houston, Texas and Newport, Delaware.

We also lease office space to provide local support services to our customers in various regions throughout the U.S. The leases on these spaces expire at various times through June 2022. We continually evaluate our current and future space capacity in relation to current and projected future staffing levels. We believe that our existing facilities are suitable and adequate to meet our current business requirements.

Item 3. ***Legal Proceedings***

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 U.S. 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, as amended (the "Securities Act") and section 10(b) of the Securities Exchange Act of 1934, as amended (the "Exchange Act") 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

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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. The motion for class certification 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. The settlement fairness hearing was held on September 10, 2009. On October 6, 2009, the Court entered an opinion granting final approval to the settlement and directing that the Clerk of the Court close the IPO Cases. Notices of appeal of this decision have been filed. Due to the inherent uncertainties of litigation and because the settlement remains subject to appeal, the ultimate outcome of the matter is uncertain, however, the Company believes that any settlement amount will be covered by its Directors and Officers insurance policy.

2004 and 2007 Derivative 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 U.S. 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 Exchange Act, and the plaintiffs sought unspecified damages. On January 13, 2009, following a motion by the parties, the Court granted final approval of the settlement of these claims, issued its final judgment on the matter, and entered an order dismissing the case with prejudice.

In 2004, two derivative lawsuits were filed in the U.S. 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, the 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

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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. 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, the plaintiffs filed a notice of appeal of the personal jurisdictional order. In light of the proposed settlement of all derivative litigation, discussed below, the court has stayed all other matters except as necessary to document and consummate the proposed settlement, pending final approval of the proposed settlement. Similarly, the appellate court has stayed all matters related to plaintiffs' notice of appeal of the personal jurisdictional order pending district court approval of the proposed settlement.

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 October 2009, the parties notified the Court of the status of the federal action and stipulated to stay the matter for an additional six months. The Court subsequently granted the parties' stipulation and stay request and ordered the parties to file an updated status report in April 2010.

In October 2009, following a voluntary mediation and subsequent negotiations related to all of the above-described derivative litigation, the parties reached an agreement in principle to settle all claims in the federal and state derivative litigation. In March 2010, the district court granted final approval of the proposed settlement and issued its Final Judgment and Order of Dismissal. In May 2010, all appeal rights expired. The details of the settlement are set forth in the settlement papers filed with the court.

Other Litigation and Government Reviews and Investigations

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 4. [Removed and Reserved.]

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PART II

Item 5. *Market For Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities*

Market Information

Our Common Stock is listed on the NASDAQ Global Select Market and is traded under the symbol "KTOS".

The following table sets forth the high and low sales prices for our Common Stock for the periods indicated, as reported by NASDAQ.

	High	Low
Year Ended December 26, 2010:		
Fourth Quarter	$ 12.37	$ 10.35
Third Quarter	$ 12.00	$ 9.36
Second Quarter	$ 15.56	$ 9.82
First Quarter	$ 15.00	$ 9.27
Year Ended December 27, 2009:		
Fourth Quarter	$ 11.90	$ 6.01
Third Quarter	$ 9.20	$ 6.60
Second Quarter	$ 9.40	$ 6.50
First Quarter	$ 14.00	$ 5.80

Holders of Record

On February 18, 2011 the last sale price of our Common Stock as reported by NASDAQ was $14.27 per share. On February 18, 2011, there were 322 shareholders of record of our Common Stock.

Dividend Policy

We have not declared any cash dividends since becoming a public company. We currently intend to retain any future earnings to finance the growth and development of the business and, therefore, do not anticipate paying any cash dividends in the foreseeable future. In addition, our credit agreement restricts our ability to pay dividends. Any future determination to pay cash dividends will be at the discretion of our board of directors and will be dependent upon the future financial condition, results of operations, capital requirements, general business conditions and other relevant factors as determined by our board of directors.

Securities Authorized for Issuance Under Equity Compensation Plans

The information required by Item 201(d) of Regulation S-K will be included in the definitive proxy statement for our 2011 annual meeting of stockholders or an amendment to this Annual Report to be filed with the SEC within 120 days after our fiscal year ended December 26, 2010, and is incorporated into this Annual Report by reference.

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Performance Graph

The following performance graph and related information shall not be deemed "soliciting material" or to be "filed" with the SEC, nor shall such information be incorporated by reference into any future filing under the Securities Act or Exchange Act, except to the extent that we specifically incorporate it by reference into such.

The following performance graph is a comparison of the five year cumulative stockholder return on our common stock against the cumulative total return of the Russell 2000 Stock Index, and an old peer group composed of ATS Corporation, Dynamic Research Corporation, NCI Inc., VSE Corporation, and WPCS International, Inc. as well as a new peer group comprised of Aerovironment Inc., Caci International Inc., General Dynamics Corp., L3 Communications Holdings Inc., Lockheed Martin Corp., Mantech International Corp., NCI Inc., SAIC Inc., SRA International Inc., and WPCS International Inc., for the period commencing December 31, 2005 and ending December 26, 2010. The performance graph assumes an initial investment of $100 in our common stock and in each of the Russell 2000 Stock Index and peer groups. The comparison also assumes that all dividends are reinvested and all returns are market-cap weighted. The historical information set forth below is not necessarily indicative of future performance.

COMPARISON OF 5 YEAR CUMULATIVE TOTAL RETURN*

Among Kratos Defense & Security Solutions, Inc, the Russell 2000 Index,
an Old Peer Group and a New Peer Group

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* $100 invested on 12/31/05 in stock or index, including reinvestment of dividends through the fiscal year ending December 26, 2010.

Recent Sales of Unregistered Securities; Use of Proceeds from Registered Securities

None.

Purchases of Equity Securities by the Issuer and Affiliated Purchasers

None.

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Item 6. *Selected Financial Data*

The following selected consolidated financial data should be read in conjunction with our consolidated financial statements and related notes thereto and with "Management's Discussion and Analysis of Financial Condition and Results of Operations" which are incorporated in Item 7 or included elsewhere in this Annual Report. Our historical results are not necessarily indicative of operating results to be expected in the future.

	December 31, 2006	December 31, 2007	December 28, 2008	December 27, 2009	December 26, 2010
	(All amounts except per share data in millions)				
Consolidated Statements of Operations Data:					
Revenues	$ 138.2	$ 180.7	$ 286.2	$ 334.5	$ 408.5
Gross profit	26.2	29.7	58.2	69.3	90.0
Operating income (loss)	(25.9)	(23.6)	(93.2)	(27.0)	23.1
Provision (benefit) for income taxes	14.5	1.3	(0.7)	1.0	(12.7)
Income (loss) from continuing operations	(41.2)	(27.2)	(104.0)	(38.3)	14.6
Loss from discontinued operations	(16.7)	(13.6)	(7.1)	(3.2)	(0.1)
Net income (loss)	$ (57.9)	$ (40.8)	$ (111.1)	$ (41.5)	$ 14.5
Income (loss) from continuing operations per common share					
Basic	$ (5.56)	$ (3.67)	$ (11.18)	$ (2.76)	$ 0.88
Diluted	$ (5.56)	$ (3.67)	$ (11.18)	$ (2.76)	$ 0.87
Loss from discontinued operations per common share					
Basic	$ (2.26)	$ (1.84)	$ (0.77)	$ (0.23)	$ (0.01)
Diluted	$ (2.26)	$ (1.84)	$ (0.77)	$ (0.23)	$ (0.01)
Net income (loss) per common share					
Basic	$ (7.82)	$ (5.51)	$ (11.95)	$ (2.99)	$ 0.87
Diluted	$ (7.82)	$ (5.51)	$ (11.95)	$ (2.99)	$ 0.86
Weighted average shares:					
Basic	7.4	7.4	9.3	13.9	16.6
Diluted	7.4	7.4	9.3	13.9	16.9

	December 31, 2006	December 31, 2007	December 28, 2008	December 27, 2009	December 26, 2010
	(All amounts in millions)				
Consolidated Balance Sheet Data:					
Cash and cash equivalents	$ 5.6	$ 8.9	$ 3.7	$ 9.9	$ 10.8
Working capital	(3.8)	23.4	35.0	37.1	65.8
Total assets	337.7	335.3	312.4	241.6	536.1
Short-term debt	51.4	2.7	6.1	4.7	0.6
Long-term debt		74.0	76.9	51.6	226.1
Total stockholders' equity	$ 187.1	$ 167.2	$ 146.9	$ 124.9	$ 169.9

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Item 7. ***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 by the DoD 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; failure to successfully consummate acquisitions or integrate acquired operations; failure to establish and maintain important relationships with government entities and agencies and other government contractors which could limit our ability to bid successfully for new business; 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 are under no obligation to update any of the forward-looking statements after the filing of this Annual Report 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 of purchased intangibles, the stock option investigation and related costs recovered in 2008, and the discussion of net debt, 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 certain expenses that would normally be included in the most directly comparable measures calculated and presented in accordance with Generally Accepted Accounting Principles ("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 we report may not be comparable to similarly titled amounts reported by other companies.

The following discussion should be read in conjunction with our audited consolidated financial statements and the related notes and other financial information appearing elsewhere in this Annual Report and other reports and filings made with the SEC. 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 this Item 7 and Item 1A Risk Factors.

Overview

We are a specialized national security business providing mission critical products, services and solutions for United States national security priorities. Our core capabilities are sophisticated engineering, manufacturing and system integration offerings for national security platforms and programs. Our principal services are related to, but are not limited to, Command, Control, Communications, Computing, Combat Systems, Intelligence, Surveillance and Reconnaissance ("C5ISR"); related cybersecurity, cyberwarfare, information assurance and situational awareness solutions; weapons systems lifecycle support and sustainment; military weapon range operations and technical services; missile, rocket and weapons system testing and evaluation; missile and rocket mission launch services, primarily for Ballistic Missile Defense; public safety, critical infrastructure security and surveillance systems; modeling and simulation; unmanned aerial vehicle systems; and advanced network engineering and information technology services. We offer our customers products, solutions, services and expertise to support their mission-critical needs by leveraging our skills across our core offering areas.

Our primary end customers are United States Federal Government agencies, including the Department of Defense, classified agencies, intelligence agencies, other National Security agencies and Homeland Security related agencies. We believe our stable client base, strong client relationships, broad array of contract vehicles, considerable employee base possessing national security clearances, extensive list of past performance qualifications, and significant management and operational capabilities position us for continued growth.

We provide products, solutions and services for a wide range of established, deployed and operating national security platforms, including, but not limited to: Aegis Ballistic Missile Defense systems, M1 Abrams tanks, Bradley fighting vehicles, F-5 Tiger, HiMARS, Chaparral and Hawk missile systems, Kiowa AH-60 helicopters, DDG-1000 Zumwalt destroyers, attack and missile submarines, certain intelligence surveillance and reconnaissance systems and various unmanned systems.

Industry Background

Department of Defense Drives Strategic Priorities for the Company

The delivery and execution of our mission-critical engineering and support services are driven by the priorities of the U.S. Federal Government and primarily the DoD. The strategic priorities of the DoD are based in large part on the Quadrennial Defense Review ("QDR"), a legislatively-mandated review of DoD strategy and priorities. These priorities are currently focused on mission critical capabilities of the U.S. armed forces and providing the support infrastructure necessary to sustain these forces in a time of heightened warfare readiness and deployment.

The DoD's budget for the 2012 fiscal year is $671 billion, a decrease of 5% from fiscal year 2011. The top 28 programs account for approximately $64 billion in funding and require aggregate funding that is nearly 14% higher than what was set aside for them in the fiscal year 2010 budget which closed on September 30, 2010. The increase in the top 28 programs represents a significant opportunity to key federal government contractors in support of the DoD's war fighter, information technology, and other operational priorities. We believe there will be significant market opportunities for providers of system sustainment, IT and engineering services and solutions to federal government agencies over the next several years, particularly those in the defense and homeland security communities.

As of February 25, 2011, the Congress has not approved the President's fiscal year ("FY") 2011 budget request. Consequently, the U.S. government, including the Department of Defense, is operating under a continuing resolution ("CR"), which funds the Pentagon at FY 2010 funding levels through early March 2011. We anticipate that Congress will further consider the FY 2011 defense spending bill in conjunction with the expiration of the current CR. This consideration would likely result in either an extension of the CR, thereby keeping FY 2011 funding at FY 2010 levels, or the passage of a 2011 funding bill.

Focus on Federal Government Transformation

The federal government and the DoD in particular, is in the midst of a significant transformation that is driven by the federal government's need to address the changing nature of global threats. A significant aspect of this transformation is the use of C5ISR, and information technology to increase the federal government's effectiveness and efficiency. The result is increased federal government spending on information technology to upgrade networks and transform the federal government from separate, isolated organizations into larger, enterprise level, network-centric organizations capable of sharing information broadly and quickly. While the transformation initiative is driven by the need to prepare for new world threats, adopting these IT transformation initiatives will also improve efficiency and reduce infrastructure costs across all federal government agencies.

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An additional aspect of the military transformation includes significantly enhancing military readiness in areas such as missile defense, weapons system sustainment and extension, and the overall strengthening of intelligence and security. For example, the objective of the DoD as it relates to missile defense is to continue to develop, test, and field missile defense systems to protect America, its allies and deployed forces.

While the real rate of growth in the top line defense budget may be slowing for the first time since September 11, 2001, the U.S. Government's budgetary process continues to give us good visibility with respect to future spending and the threat areas that the government is addressing. We believe that our business is aligned with mission critical national security priorities particularly in the area of missile defense, C5ISR, cyber security and information assurance and that our current contracts and strong backlog provide us with good insight regarding our future cash flows.

Current Reporting Segments

We operate in two principal business segments: Kratos Government Solutions and Public Safety & Security. 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 consolidated financial statements in this Annual Report are presented in a manner consistent with our operating structure. For additional information regarding our operating segments, see Note 14 of Notes to 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 Segment

Our KGS segment provides products, solutions and services primarily for mission critical National Security priorities. KGS customers primarily include National Security related agencies, the Department of Defense, intelligence agencies and classified agencies. Our work includes weapon systems sustainment, lifecycle support and extension; C5ISR services, including related cybersecurity, cyberwarfare, information assurance and situational awareness solutions; military range operations and technical services; missile, rocket, and weapons systems test and evaluation; mission launch services; modeling and simulation; UAV products and technology; advanced network engineering and information technology services; and public safety, security and surveillance systems integration. We produce products, solutions and services related to certain C5ISR platforms, unmanned system platforms, weapons systems, national security related assets and warfighter systems. The results of our recent acquisitions of Southside, DEI and Gichner are included in this segment.

Public Safety & Security Segment

Our PSS segment provides independent integrated solutions for advanced homeland security, public safety, critical information, security and surveillance systems for government and commercial applications. Our solutions include designing, installing and servicing building technologies that protect people, critical infrastructure, assets, information and property and make facilities more secure and efficient. We provide solutions in such areas as the design, engineering and operation of command and control centers, the design, engineering, deployment and integration of access control, building automation and control, communications, digital and closed circuit television security and surveillance, fire and life safety, maintenance and services and product support services. We provide solutions for customers in the critical infrastructure, power generation, power transport, nuclear energy, financial, information technology, healthcare, education, transportation and petro-chemical industries, as well as certain government and military customers. For example, we provide biometrics and other access control technologies to customers such as pipelines, electrical grids, municipal port authorities, power

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plants, communication centers, large data centers, government installations and other commercial enterprises. The results of our recent acquisition of HBE are included in this segment.

On June 24, 2009, as a result of the continued operating losses in the Southeast division of the PSS segment (the "Southeast Division"), our board of directors approved a plan to sell and dispose of the Southeast Division. In accordance with *ASC Topic 205, Presentation of Financial Statements ("Topic 205")*, this business unit was classified as held for sale and reported in discontinued operations in the accompanying consolidated financial statements. We recorded a $2.0 million impairment charge in the second quarter of 2009 and an additional $0.2 million in the second quarter of 2010 related to management's estimate of the fair value of the business. On August 2, 2010, we divested this division for approximately $0.1 million cash consideration and the assumption of certain liabilities.

Strategic Acquisitions

Henry Bros. Electronics, Inc.

On December 15, 2010, we acquired Henry Bros. Electronics, Inc. in a cash merger for a purchase price of $56.6 million, of which $54.9 million was paid in cash and $1.7 million reflects the fair value of options to purchase common stock of HBE that were assumed by us and converted into options to purchase our common stock upon completion of the merger. Upon completion of the merger, holders of HBE common stock received $8.20 in cash for each share of HBE common stock held by them immediately prior to the closing of the merger. In addition, upon completion of the merger, all options to purchase HBE common stock were assumed by us (the "Assumed Options") and converted into options to purchase our common stock, entitling the holders thereof to receive 0.7715 shares of our common stock for each share of HBE common stock underlying the Assumed Options. The Assumed Options will be exerciseable for an aggregate of approximately 0.4 million shares of our common stock.

HBE is a leading provider of homeland security solutions, products, and system integration services, including the design, engineering and operation of command, control and surveillance systems for the protection of strategic assets and critical infrastructure in the U.S. HBE also has particular expertise in the design, engineering, deployment and operation of specialized surveillance, thermal imaging, analytics, radar, and biometrics technology based security systems. Representative HBE programs and customers include DoD agencies, nuclear power generation facilities, state government and municipality related agencies, major national airports, major harbors, railways, tunnel systems, energy centers, power plants, and related infrastructure.

Southside Container & Trailer, LLC.

On December 7, 2010, we acquired Southside for $13.7 million of which $12.2 million in cash was paid at closing, $0.3 million is being held as security for SCT's indemnification obligations as set forth in the Purchase Agreement and approximately $1.2 million of which represents the acquisition date fair value of additional performance based consideration. The potential undiscounted amount of all future contingent consideration that may be payable by us under the Purchase Agreement is $3.5 million. Southside is a privately-held provider of national security related command and control center, law enforcement, military aviation and data center products, shelters and solutions for the United States Department of Defense, National Security agencies and related customers. Southside also provides products and solutions for specialized war fighter and critical asymmetric warfare related missions.

DEI Services Corporation

On August 9, 2010, we acquired DEI Services Corporation, in a cash merger valued at approximately $14.0 million, of which $9.0 million was paid in cash at closing and approximately $5.0 million of which represented the acquisition date fair value of additional performance-based consideration, of which $0.4 million was achieved and paid in September 2010. Pursuant to the terms of

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the DEI Agreement upon achievement of certain cash receipts, revenue, earnings before interest, taxes, depreciation, and amortization ("EBITDA") and backlog amounts in 2010, 2011 and 2012, we will be obligated to pay the former stockholders of DEI certain additional contingent consideration. The potential undiscounted amount of all future contingent consideration that may be payable by us under the DEI Agreement, subsequent to December 26, 2010, is between zero and $8.0 million. The contingent consideration will be reduced in the event certain anticipated cash receipts are not collected within agreed upon time periods, which could decrease the future payments by approximately $6.0 million.

Founded in 1996 and headquartered in Orlando, Florida, DEI designs, manufactures and markets full-scale training simulation products. In addition to the engineering and construction of physical simulators for air and ground military vehicles, DEI provides instructional design, courseware creation, learning application programming and other supporting services. Among DEI's most successful products are training and simulation solutions for fixed-wing aircraft (including the Tiger, Harrier and Prowler aircraft), rotor-wing aircraft (including Blackhawk, Chinook and Sea Stallion helicopters) and Ground Combat Vehicles (including M1 Abrams Main Battle Tank and M2 Bradley Fighting Vehicle).

Gichner Holdings, Inc.

On May 19, 2010, we acquired Gichner pursuant to the Stock Purchase Agreement, dated as of April 12, 2010, by and between us and the stockholders of Gichner (the "Purchase Agreement"), in a cash for stock transaction valued at approximately $133.0 million. Gichner has manufacturing and operating facilities in Dallastown and York, Pennsylvania and Charleston, South Carolina, and is a manufacturer of tactical military products, combat support facilities, subsystems, modular systems and shelters primarily for the DoD and leading defense system providers. Representative programs for which Gichner provides products and solutions include the MQ 1C Sky Warrior, Gorgon Stare, MQ 8B Fire Scout and RQ 7 Shadow Unmanned Aerial Vehicles, the Command Post Platform and Joint Light Tactical Vehicles, Combat Tactical Vehicles, DDG-1000 Modular C5 Compartments and the Persistent Threat Detection System ISR Platform.

Upon completion of the acquisition, we deposited $8.1 million of the purchase price into an escrow account as security for Gichner's indemnification obligations as set forth in the Purchase Agreement. In addition, the Purchase Agreement provides that the purchase price will be (i) increased on a dollar for dollar basis if the working capital on the closing date (as defined in the Purchase Agreement) exceeds $17.5 million or (ii) decreased on a dollar for dollar basis if the working capital is less than $17.1 million. Kratos and Altus Capital Partners, Inc., the seller's representative under the Purchase Agreement (the "Seller's Representative") have agreed to a working capital adjustment of $0.3 million owed to us. The Seller's Representative is disputing an additional working capital adjustment of $0.9 million to which we believe we are entitled.

Digital Fusion, Inc.

On December 24, 2008, we acquired DFI. DFI provides C4ISR and technical engineering services, UAV products and technology and has significant engineering, modeling and simulation capabilities. The acquisition of DFI provided 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.

We acquired DFI in a stock for stock transaction valued at approximately $37.0 million, including transaction costs of $0.9 million. We issued 2.3 million shares to DFI shareholders and assumed outstanding DFI options, which resulted in the assumption of options to acquire approximately

1.0 million shares of our common stock. The value of the purchase price related to the common stock issued was derived from the number of shares of our common stock issued of 2.3 million, based on 12.8 million shares of DFI common stock outstanding and the exchange ratio of 0.17933 for each DFI share, at a price of $12.70 per share, the average closing price of our 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.

SYS Technologies

On June 28, 2008, we acquired SYS. SYS provided a range of C4ISR and net-centric solutions to federal, state, and local governments as well as other customers. The combination of SYS and Kratos created a broad, complementary set of offerings, and positioned 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 purchase price of $55.9 million included direct transaction costs of $2.4 million and restructuring costs of $2.6 million to be paid by us. The value of the purchase price related to the common stock issued was derived from the number of shares of our common stock issued of 2.5 million, based on 20.1 million shares of SYS common stock outstanding and the exchange ratio of 0.12582 for each SYS share, at a price of $20.22 per share, the average closing price of our 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.

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 PSS businesses. In accordance with *Topic 205*, these business units were classified as held for sale and reported in discontinued operations. In the quarter ended March 29, 2009, all three of the businesses were sold for an aggregate cash consideration of approximately $0.4 million.

Key Financial Statement Concepts

As of December 26, 2010, we consider the following factors to be important in understanding our financial statements.

KGS' business with the U.S. Government and prime contractors is generally performed under 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 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. In accounting for our long-term contracts for production of products and services provided to the federal government and provided to our PSS customers under fixed price contracts, we utilize both cost-to-cost and units produced measures under the percentage-of-completion method of accounting under the provisions of *FASB ASC Topic 605, Revenue Recognition ("Topic 605")*. Under the units produced measure of the percentage-of-completion method of accounting, sales are recognized as the units are accepted by the customer generally using sales values for units in accordance with the contract terms. We estimate profit as the difference between total estimated revenue and total estimated cost of a contract and recognize that profit over the life of the contract based on deliveries or as computed on the basis of the estimated final average unit costs plus profit. We classify contract revenues as product

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sales or service revenues depending upon the predominant attributes of the relevant underlying contracts.

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

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

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

Results of Operations

Comparison of Results for the Year Ended December 27, 2009 to the Year ended December 26, 2010

Revenues. Revenues by operating segment for the years ended December 27, 2009 and December 26, 2010 are as follows (in millions):

	2009	2010	$ change	% change
Kratos Government Solutions Segment	$ 304.3	$ 372.2	$ 67.9	22.3%
Public Safety & Security Segment	30.2	36.3	6.1	20.2%
Total revenues	$ 334.5	$ 408.5	$ 74.0	22.1%

Revenues increased $74.0 million from $334.5 million in 2009 to $408.5 million in 2010. This increase was primarily due to the acquisitions of Gichner and DEI and to a lesser extent by the acquisitions of Southside and HBE. Gichner and DEI contributed aggregate revenues of $104.8 million, and Southside and HBE contributed combined revenues of $1.9 million.

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Product sales which are all from the KGS segment increased $103.2 million from $20.5 million for the year ended December 27, 2009 to $123.7 million for the year ended December 26, 2010. As a percentage of total revenue, product revenues were 6.1% for the year ended December 27, 2009 as compared to 30.3% for the year ended December 26, 2010. This increase was primarily related to an air defense weapon system munitions contract we were awarded during the first quarter of 2010 and the acquisitions of Gichner and DEI. Service revenue decreased by $29.2 million from $314.0 million for the year ended December 27, 2009 to $284.8 million for the year ended December 26, 2010. The decrease in service revenue was a result of the planned reductions of lower margin pass through work and to a lesser extent expected reductions of small business set aside contract work from companies we previously acquired and in-sourcing of our employees by the U.S. Government in certain of our businesses in the KGS segment. The increase in revenue in the PSS segment is a result of an increase in security integration projects for critical infrastructure such as pipelines, power productions facilities and data centers, as well as revenue from the acquisition of HBE.

As described in the section "Critical Accounting Principles and Estimates" and in the Notes to Consolidated Financial Statements, we utilize both the cost-to-cost and units produced measures under the percentage-of-completion method of accounting for recognizing revenue as provided for in *Topic 605*. When revenue is calculated using the percentage-of-completion method, total costs incurred to date are compared to total estimated 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 projects, which determine the project's percentage of completion, 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. During the reporting periods contained herein, we did experience revenue and margin adjustments of certain projects based on the aforementioned factors, but the effect of such adjustments, both positive and negative, when evaluated in total were determined to be immaterial to the consolidated financial statements.

Cost of revenues. Cost of revenues increased from $265.2 million for the year ended December 27, 2009 to $318.5 million for the year ended December 26, 2010. The $53.3 million increase in cost of revenues was primarily a result of the acquisition of Gichner and DEI and to a lesser extent by the acquisitions of Southside and HBE partially offset by reductions in revenue and reduced costs as a result of increased margins due to planned reductions of lower margin pass though work in our KGS segment. Gichner and DEI incurred combined cost of revenues of $85.4 million and Southside and HBE incurred combined cost of revenues of $1.2 million. Gross margin increased from 20.7% for the year ended December 27, 2009 to 22.0% for the year ended December 26, 2010. This was primarily the result of the increase in margin on service revenue from 20.4% to 24.3% for the year ended December 27, 2009 and December 26, 2010, respectively. This increase was due primarily to the planned reductions of lower margin pass through work. Gross margins on product sales decreased for the year ended December 26, 2010 as compared to December 27, 2009 from 25.9% to 16.7%, respectively, as a result of the Gichner acquisition and the associated product mix. Margins in the PSS segment increased from 29.5% for the year ended December 27, 2009 to 32.0% for the year ended December 26, 2010 as a result of performance improvements and revenue growth.

Selling, general and administrative expenses. Selling, general and administrative expenses ("SG&A") increased $10.2 million from $52.8 million to $63.0 million for the years ended December 27, 2009 and December 26, 2010, respectively. The increase of $10.2 million was primarily due to an increase in costs of $12.5 million from the acquisitions of Gichner, DEI, Southside, and HBE. Included in the SG&A expenses for 2009 and 2010 are amortization of purchased intangibles of $5.7 million and $9.2 million, respectively. The increase in amortization year over year was primarily a result of the Gichner and DEI

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acquisitions. As a percentage of revenues, selling, general and administrative expenses decreased from 15.8% in 2009 to 15.4% in 2010. Excluding the impact of the amortization of purchased intangibles, SG&A expenses decreased from 14.1% to 13.2% of revenues for 2009 and 2010, respectively, reflecting leverage on increased revenues.

Research and development expenses. Research and development ("R&D") expenses were $1.8 million for the year ended December 27, 2009 and $2.2 million for the year ended December 26, 2010.

Recovery of unauthorized issuance of stock options, stock option investigation and related fees and litigation settlement. In October 2009, we reached an agreement with the plaintiffs to settle the outstanding 2004 and 2007 derivative lawsuits. The benefit in 2009 of $0.2 million is a result of the reduction in our estimated accrual related to this litigation, offset by expenses related to government inquiries by the Department of Justice ("DOJ"), which were completed in 2009, related to our historical stock option granting practices. In September 2010, we reached a settlement with one of our D&O insurance carriers to cover costs related to our completed stock option and DOJ investigations. The settlement received, net of legal expenses, was $1.4 million.

Impairment of goodwill. During the first quarter of 2009, we determined that a triggering event had occurred in accordance with *Topic 350*. This resulted in an impairment charge of $41.3 million during the first quarter of 2009. The impairment charge was primarily driven by adverse equity market conditions that caused a decrease in 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 performed our analysis. The average market price of our stock as of February 28, 2009 was $7.80 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 $12.90. 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 from a commercial wireless service provider to a U.S. government defense contractor. The decline in revenues, 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. Certain of the contract awards that were legacy small business awards to businesses which we acquired may result in a reduction of revenues when the contracts are completed and recompeted and awarded to us as a subcontractor rather than as a prime contractor. We believe that the expected impact to our revenues will not be material related to this conversion. 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. In addition, we did not assume a recovery of the global or national economy in our cash flow projections in our analysis as of December 28, 2008 or in our analysis as of February 28, 2009. The charge does not impact our normal business operations.

Impairments and adjustments to the liability for unused office space. The expense of $0.6 million for the year ended December 27, 2009, was a result of a change in our excess facility accrual due to the consolidation of space at our corporate headquarters following the sale of the SYS commercial businesses and a cancellation of a sublease of one of our tenants due to financial difficulties.

Merger and acquisition expenses. Merger and acquisition expenses were $3.1 million for the year ended December 26, 2010, primarily related to our acquisitions of Gichner, DEI, Southside, and HBE. We had no acquisition expenses for the year ended December 27, 2009.

Other expense, net. For the year ended December 27, 2009, net other expense was $10.3 million compared to net other expense of $21.2 million for the year ended December 26, 2010. The increase in other expense of $10.9 million is primarily related to an increase in interest expense of $3.9 million as a result of the write-off of deferred financing fees associated with our prior credit facilities and an increase in interest expense as a result of the $225.0 million in notes issued in May 2010, primarily to fund the acquisition of Gichner, partially offset by a decrease of $1.0 million in other expense primarily related to the non-cash charges to mark our interest rate derivatives to market.

Provision (benefit) for income taxes. The provision for income taxes decreased from a provision of $1.0 million on a loss of $37.3 million before income taxes for the year ended December 27, 2009 to a benefit of $12.7 million on income before income taxes of $1.9 million for the year ended December 26, 2010. The provision for the year ended December 27, 2009 was primarily due to current state taxes. The benefit for the year ended December 26, 2010 was primarily related to the acquisitions of Gichner and DEI. In accordance with *FASB ASC Topic 805 Business Combinations ("Topic 805"),* we established deferred tax liabilities of approximately $18.2 million for the increase in the financial statement basis of the acquired assets of Gichner, and DEI, respectively. As a result of our ability to recognize deferred tax assets for certain of these deferred tax liabilities, we released the valuation allowances against our deferred tax assets and recognized an income tax benefit of $13.6 million.

Loss from discontinued operations. Loss from discontinued operations improved from a loss of $3.2 million to a loss of $0.1 million for the year ended December 27, 2009 and December 26, 2010, respectively. In 2009, $2.0 million of the loss was related to the impairment of assets related to the Southeast Division recorded to reflect management's estimate of the fair value of this business. In 2010, the loss was primarily due to a reduction in liabilities as a result of the final settlement of sales and use tax liabilities related to our discontinued wireless deployment business partially offset by losses in the Southeast Division. Revenues generated by these businesses were approximately $5.9 million and $2.2 million for the year ended December 27, 2009 and December 26, 2010, respectively. Excluding the impairment charge, losses before taxes were $1.8 million for the year ended December 27, 2009 and $0.9 million for the year ended December 26, 2010. For the year ended December 27, 2009 and December 26, 2010, we recognized a tax benefit of $0.6 million and $0.8 million, respectively, primarily related to the expiration of the statute of limitations for certain domestic and foreign tax contingencies. In August 2010, we divested our Southeast Division for approximately $0.1 million cash consideration and the assumption of certain liabilities.

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

	Year ended December 27, 2009	Year ended December 26, 2010
Revenue	$ 5.9	$ 2.2
Loss before taxes	(3.8)	(0.9)
Benefit for income taxes	(0.6)	(0.8)
Net loss	$ (3.2)	$ (0.1)

See Note 9 to the Notes to the Consolidated Financial Statements for a further discussion of discontinued operations.

Comparison of Results for the Year Ended December 28, 2008 to the Year ended December 27, 2009

Revenues. Revenues by operating segment for the years ended December 28, 2008 and December 27, 2009 are as follows (in millions):

	2008	2009	$ change	% change
Kratos Government Solutions Segment	$ 246.7	$ 304.3	$ 57.6	23.3%
Public Safety & Security Segment	39.5	30.2	(9.3)	(23.5)%
Total revenues	$ 286.2	$ 334.5	$ 48.3	16.9%

Revenues increased $48.3 million from $286.2 million in 2008 to $334.5 million in 2009. The increase of $57.6 million in our Kratos Government Solutions segment was partially due to the acquisitions of DFI on December 24, 2008 and SYS on June 28, 2008 which resulted in an increase in revenue of $88.6 million. This increase in revenue was partially offset by reductions due to the substantial completion of two weapons systems contracts, the planned reductions of acquired small business set aside contract work, pass through work and other contract work in the Kratos Government Solutions segment. The PSS segment was negatively impacted by an adverse economic environment as a result of delays in capital improvement projects and the construction of new buildings.

Product sales decreased $6.2 million from $26.7 million for the year ended December 28, 2008 to $20.5 million for the year ended December 27, 2009. As a percentage of total revenue, product revenues were 9.3% for the year ended December 28, 2008 as compared to 6.1% for the year ended December 27, 2009. This decrease was primarily related to the substantial completion of two weapons systems contracts.

As described in the section "Critical Accounting Principles and Estimates" and in the notes to consolidated financial statements, we utilize both the cost-to-cost and units produced measures under the percentage-of-completion method of accounting for recognizing revenue as provided for in *Topic 605*. When revenue is calculated using the percentage-of-completion method, total costs incurred to date are compared to total estimated 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 projects, 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. During the reporting periods contained herein, we did experience revenue and margin adjustments of certain projects based on the aforementioned factors, but the effect of such adjustments, both positive and negative, when evaluated in total were determined to be immaterial to the consolidated financial statements.

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Cost of revenues. Cost of revenues increased $37.2 million or 16.3% from $228.0 million for the year ended December 28, 2008 to $265.2 million for the year ended December 27, 2009 primarily due to the increase in total revenues. The increase was primarily attributable to cost of revenues of approximately $74.5 million related to the DFI and SYS acquisitions, partially offset by reduced costs related to the reductions in revenues described above. Gross margin during the year ended December 27, 2009 of 20.7% increased slightly from a 2008 gross margin of 20.3%.

Selling, general and administrative expenses. Selling, general and administrative expenses ("SG&A") increased 8.0% from $48.9 million to $52.8 million for the years ended December 28, 2008 and December 27, 2009, respectively. The increase of $3.9 million was partially due to an increase in costs of $7.3 million from the acquisitions of DFI and SYS, offset by a decrease in corporate and other expenses in our commercial divisions due to the implementation of cost reduction initiatives. Included in the selling, general and administrative expenses for 2008 and 2009 are amortization of purchased intangibles of $4.9 million and $5.7 million, respectively. The increase in amortization year over year was primarily a result of the DFI and SYS acquisitions. As a percentage of revenues, selling, general and administrative expenses decreased from 17.1% in 2008 to 15.8% in 2009. Excluding the impact of the amortization of purchased intangibles, SG&A expenses decreased from 15.4% to 14.1% of revenues for 2008 and 2009, respectively, reflecting the leverage on increased revenues and the implementation of cost reduction initiatives.

Research and development expenses. Research and development expenses increased from $0.9 million for the year ended December 28, 2008 to $1.8 million for the year ended December 27, 2009 as a result of R&D expenses incurred by DFI and SYS which were acquired on December 24, 2008 and June 28, 2008, respectively.

Recovery of unauthorized issuance of stock options, stock option investigation and related fees and litigation settlement. In 2008, we recovered $4.5 million, through insurance reimbursements, of costs and losses related to the stock option investigation in 2007. In September 2009, we reached an agreement with the plaintiffs to settle the outstanding 2004 and 2007 derivative lawsuits. The benefit in 2009 of $0.2 million is a result of the reduction in our estimated accrual related to this litigation, offset by expenses related to government inquiries by the DOJ, which was completed in 2009, related to our historical stock option granting practices.

Impairment of goodwill. In December 2008, we concluded that the decision to exit three businesses obtained with the SYS acquisition and included with our KGS reporting segment met the criteria to be classified as held for sale and was a triggering event under *Topic 350* that required a review of goodwill and intangible assets with indefinite lives. Because the three business units were never integrated into the KGS reporting unit, and the benefits of the acquired goodwill were never realized by the rest of the reporting unit, the goodwill of the disposed businesses was not adjusted based upon the relative fair values of the businesses disposed and businesses retained.

Because of the timing of the disposals mentioned above, the required impairment test of the KGS goodwill and intangible assets with indefinite lives was included with our required annual impairment test of goodwill. The annual impairment test for goodwill was performed using a discounted cash flow ("DCF") analysis supported by comparative market multiples to determine the fair values of our segments versus their book values. The test as of December 28, 2008, indicated that the book values for the KGS segment, excluding DFI (which was purchased on December 24, 2008), exceeded the fair values of these businesses and resulted in our recording a non-cash charge totaling $105.8 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 market multiples and our average stock price as of December 28, 2008, compared with the impairment test performed as of December 31, 2007. 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 December 28, 2008 was $12.90 which equates to a 45% drop in our average stock price and corresponding market capitalization from December 31, 2007 which had an average stock price of $23.50. 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 WACC increased 250 basis points from 11.5% in our year end impairment test in 2007 compared to 14% in our year end impairment test in 2008. This change was the key factor contributing to the $105.8 million impairment charge that we recorded in the fourth quarter of 2008.

During the first quarter of 2009, we determined that a triggering event had occurred in accordance with *Topic 350*. This resulted in an impairment charge of $41.3 million during the first quarter of 2009. The impairment charge was primarily driven by adverse equity market conditions that caused a decrease in 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 performed our analysis. The average market price of our stock as of February 28, 2009 was $7.80 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 $12.90. 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 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 from a commercial wireless service provider to a U.S. government defense contractor. The decline in revenues, 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. Certain of the contract awards that were legacy small business awards to businesses which we acquired may result in a reduction of revenues when the contracts are completed and recompeted and awarded to us as a subcontractor rather than as a prime contractor. We believe that the expected impact to our revenues will not be material related to this conversion. 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. In addition, we did not assume a recovery of the global or national economy in our cash flow projections in our analysis as of December 28, 2008 or in our analysis as of February 28, 2009. The charge does not impact our normal business operations.

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Impairment and adjustments to the liability for unused office space. The expense of $0.3 million for the year ended December 28, 2008 was a result of a change in estimate of our excess facility accrual for obligations under facility leases and a write-off of fees related to the withdrawal of our previously filed S-3 and S-4 registration statements, which were no longer useable as a result of a change in regulations. The expense of $0.6 million for the year ended December 27, 2009, was a result of a change in our excess facility accrual due to the consolidation of space at our corporate headquarters following the sale of the SYS commercial businesses and a cancellation of a sublease of one of our tenants due to financial difficulties.

Other expense, net. For the year ended December 28, 2008, net other expense was $11.5 million compared to net other expense of $10.3 million for the year ended December 27, 2009. The decrease in expense of $1.2 million for the year ended December 27, 2009 as compared to the year ended December 28, 2008 was primarily driven by a decrease in other expense of $1.6 million as a result of the non-cash charge to mark the derivative related to our credit facility to market. This decrease in other expense was partially offset by an increase in interest expense of $0.7 million related to the acceleration of the amortization of deferred financing costs due to a $17.5 million early extinguishment of the first lien term loan in October 2009. For additional information regarding this extinguishment of debt, see Note 5 of Notes to Consolidated Financial Statements.

Provision (benefit) for income taxes. Our effective income tax rate for the year ended December 27, 2009 represented a negative 3% income tax provision compared to a positive 1% income tax benefit for the year ended December 28, 2008. The tax provision for the year ended December 27, 2009 was primarily related to current state income taxes of $1.0 million. The tax benefit of $0.7 million for the year ended December 28, 2008 was comprised of current state income taxes of $1.3 million offset by a benefit of $2.0 million related to a reduction in deferred tax liabilities as a result of the goodwill impairment charge.

Loss from discontinued operations. Loss from discontinued operations decreased from a loss of $7.1 million for the year ended December 28, 2008 to a loss of $3.2 million for the year ended December 27, 2009.

In December 2008, we made the decision to exit three of our acquired SYS businesses that were not core to our stated strategy and that had been dilutive to our profitability. The businesses divested or exited provided interactive video surveillance and information analysis products, digital broadcasting products and incident response management systems. These actions were taken as part of our ongoing integration efforts of recently acquired companies and cost reduction initiatives. In 2008, $4.5 million of the loss is related to asset impairments including goodwill. In 2009, $2.0 million of the loss was related to the impairment of assets of the Southeast Division of PSS which reflected management's estimate of the fair value of the business.

On June 24, 2009, as a result of the continued operating losses in the Southeast Division of our PSS segment, the board of directors approved a plan to sell and dispose of the Southeast Division. In accordance with *Topic 205*, this business unit was classified as held for sale and reported in discontinued operations in the accompanying consolidated financial statements. We 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. We continued to operate the Southeast Division while simultaneously seeking a buyer. The negative cash flow from discontinued operations was primarily a result of this division's continuing business activities.

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

	Year Ended December 28, 2008	December 27, 2009
Revenue	$ 13.1	$ 5.9
Loss before taxes	(8.4)	(3.8)
Benefit for income taxes	(1.3)	(0.6)
Net loss	$ (7.1)	$ (3.2)

See Note 9 to the Notes to the Consolidated Financial Statements for a further discussion of discontinued operations.

Liquidity and Capital Resources

As of December 26, 2010, we had consolidated cash and cash equivalents of $10.8 million,