EL PASO ELECTRIC CO /TX/
Form 10-Q
November 04, 2016
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Form 10-Q
(Mark One)
x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended September 30, 2016
OR
o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from _______ to _______
Commission file number 001-14206
El Paso Electric Company
(Exact name of registrant as specified in its charter)

Texas	74-0607870
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
Stanton Tower, 100 North Stanton, El Paso, Texas	79901
(Address of principal executive offices)	(Zip Code)

(915) 543-5711
(Registrant’s telephone number, including area code)
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 x NO o
Indicate by check mark whether the registrant 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 (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). YES x NO o
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See definitions of “large accelerated filer”, “accelerated filer” and “smaller reporting company” in Rule 12b-2 of the Exchange Act.

Large accelerated filer	x	Accelerated filer	o
Non-accelerated filer	o	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 x
As of October 31, 2016, there were 40,522,246 shares of the Company’s no par value common stock outstanding.

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

EL PASO ELECTRIC COMPANY
BALANCE SHEETS

	September 30, 2016 (Unaudited)	December 31, 2015
ASSETS		
(In thousands)		
Utility plant:		
Electric plant in service	$ 3,746,141	$ 3,616,301
Less accumulated depreciation and amortization	(1,228,659)	(1,329,843)
Net plant in service	2,517,482	2,286,458
Construction work in progress	153,868	293,796
Nuclear fuel; includes fuel in process of $64,292 and $51,854, respectively	201,993	190,282
Less accumulated amortization	(85,895)	(75,031)
Net nuclear fuel	116,098	115,251
Net utility plant	2,787,448	2,695,505
Current assets:		
Cash and cash equivalents	10,044	8,149
Accounts receivable, principally trade, net of allowance for doubtful accounts of $2,260 and $2,046, respectively	112,697	66,326
Inventories, at cost	47,498	48,697
Under-collection of fuel revenues	8,962	—
Prepayments and other	12,856	9,872
Total current assets	192,057	133,044
Deferred charges and other assets:		
Decommissioning trust funds	254,626	239,035
Regulatory assets	122,054	115,127
Other	16,488	17,896
Total deferred charges and other assets	393,168	372,058
Total assets	$ 3,372,673	$ 3,200,607

See accompanying notes to financial statements.

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EL PASO ELECTRIC COMPANY
BALANCE SHEETS (Continued)

	September 30, 2016 (Unaudited)	December 31, 2015
CAPITALIZATION AND LIABILITIES		
(In thousands except for share data)		
Capitalization:		
Common stock, stated value $1 per share, 100,000,000 shares authorized, 65,671,235 and 65,709,819 shares issued, and 156,976 and 118,834 restricted shares, respectively	$ 65,828	$ 65,829
Capital in excess of stated value	321,629	320,073
Retained earnings	1,121,487	1,067,396
Accumulated other comprehensive loss, net of tax	(12,337)	(13,914)
	1,496,607	1,439,384
Treasury stock, 25,305,965 and 25,384,834 shares, respectively, at cost	(421,532)	(422,846)
Common stock equity	1,075,075	1,016,538
Long-term debt, net of current portion	1,195,397	1,122,660
Total capitalization	2,270,472	2,139,198
Current liabilities:		
Current maturities of long-term debt	83,081	—
Short-term borrowings under the revolving credit facility	55,192	141,738
Accounts payable, principally trade	70,486	59,978
Taxes accrued	35,127	30,351
Interest accrued	19,349	12,649
Over-collection of fuel revenues	1,219	4,023
Other	29,543	28,325
Total current liabilities	293,997	277,064
Deferred credits and other liabilities:		
Accumulated deferred income taxes	549,846	495,237
Accrued pension liability	83,366	90,527
Accrued post-retirement benefit liability	56,398	54,553
Asset retirement obligation	80,086	81,621
Regulatory liabilities	18,495	24,303
Other	20,013	38,104
Total deferred credits and other liabilities	808,204	784,345
Commitments and contingencies		
Total capitalization and liabilities	$ 3,372,673	$ 3,200,607

See accompanying notes to financial statements.

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EL PASO ELECTRIC COMPANY
STATEMENTS OF OPERATIONS
(Unaudited)
(In thousands except for share data)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Operating revenues	$323,225	$289,713	$698,899	$672,967
Energy expenses:				
Fuel	54,355	60,798	131,817	148,340
Purchased and interchanged power	24,459	19,520	47,715	42,437
	78,814	80,318	179,532	190,777
Operating revenues net of energy expenses	244,411	209,395	519,367	482,190
Other operating expenses:				
Other operations	64,373	65,360	179,577	178,615
Maintenance	14,064	14,355	52,005	49,772
Depreciation and amortization	15,952	22,380	63,097	67,080
Taxes other than income taxes	20,165	19,253	50,297	48,844
	114,554	121,348	344,976	344,311
Operating income	129,857	88,047	174,391	137,879
Other income (deductions):				
Allowance for equity funds used during construction	1,398	1,874	5,867	8,417
Investment and interest income, net	3,773	5,912	10,293	12,564
Miscellaneous non-operating income	272	850	1,073	1,537
Miscellaneous non-operating deductions	(1,312)	(1,015)	(2,668)	(2,777)
	4,131	7,621	14,565	19,741
Interest charges (credits):				
Interest on long-term debt and revolving credit facility	18,324	16,465	53,221	49,443
Other interest	268	424	1,102	941
Capitalized interest	(1,243)	(1,208)	(3,738)	(3,758)
Allowance for borrowed funds used during construction	(1,131)	(1,353)	(4,164)	(5,365)
	16,218	14,328	46,421	41,261
Income before income taxes	117,770	81,340	142,535	116,359
Income tax expense	43,134	24,600	51,423	35,089
Net income	$74,636	$56,740	$91,112	$81,270
Basic earnings per share	$1.84	$1.40	$2.25	$2.01
Diluted earnings per share	$1.84	$1.40	$2.25	$2.01
Dividends declared per share of common stock	$0.310	$0.295	$0.915	$0.870
Weighted average number of shares outstanding	40,363,819	40,289,010	40,344,834	40,267,533
Weighted average number of shares and dilutive potential shares outstanding	40,425,942	40,329,529	40,395,811	40,299,801

See accompanying notes to financial statements.

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EL PASO ELECTRIC COMPANY
STATEMENTS OF OPERATIONS
(Unaudited)
(In thousands except for share data)

	Twelve Months Ended September 30,	
	2016	2015
Operating revenues	$875,801	$869,530
Energy expenses:		
Fuel	171,877	207,564
Purchased and interchanged power	58,823	53,127
	230,700	260,691
Operating revenues net of energy expenses	645,101	608,839
Other operating expenses:		
Other operations	243,912	241,510
Maintenance	67,456	69,782
Depreciation and amortization	85,841	88,086
Taxes other than income taxes	65,189	62,711
	462,398	462,089
Operating income	182,703	146,750
Other income (deductions):		
Allowance for equity funds used during construction	8,089	12,864
Investment and interest income, net	15,237	17,660
Miscellaneous non-operating income	1,598	3,453
Miscellaneous non-operating deductions	(4,219)	(4,922)
	20,705	29,055
Interest charges (credits):		
Interest on long-term debt and revolving credit facility	69,629	64,668
Other interest	1,474	1,292
Capitalized interest	(4,948)	(5,053)
Allowance for borrowed funds used during construction	(5,736)	(7,892)
	60,419	53,015
Income before income taxes	142,989	122,790
Income tax expense	51,229	37,279
Net income	$91,760	$85,511
Basic earnings per share	$2.27	$2.12
Diluted earnings per share	$2.27	$2.12
Dividends declared per share of common stock	$1.21	$1.15
Weighted average number of shares outstanding	40,332,835	40,255,439
Weighted average number of shares and dilutive potential shares outstanding	40,380,443	40,279,640

See accompanying notes to financial statements.

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EL PASO ELECTRIC COMPANY
STATEMENTS OF COMPREHENSIVE OPERATIONS
(Unaudited)
(In thousands)

	Three Months Ended September 30,		Nine Months Ended September 30,		Twelve Months Ended September 30,	
	2016	2015	2016	2015	2016	2015
Net income	$74,636	$56,740	$91,112	$81,270	$91,760	$85,511
Other comprehensive income (loss):						
Unrecognized pension and post-retirement benefit costs:						
Net gain (loss) arising during period	—	—	—	—	5,429	(74,028)
Prior service benefit	—	—	—	—	824	34,200
Reclassification adjustments included in net income for amortization of:						
Prior service benefit	(1,663)	(1,606)	(4,993)	(4,931)	(6,636)	(6,996)
Net loss	1,087	1,966	3,532	6,466	5,688	8,081
Net unrealized gains/losses on marketable securities:						
Net holding gains (losses) arising during period	4,313	(8,092)	9,293	(8,641)	15,028	(5,779)
Reclassification adjustments for net gains included in net income	(2,072)	(4,324)	(5,570)	(7,887)	(8,797)	(11,446)
Net losses on cash flow hedges:						
Reclassification adjustment for interest expense included in net income	126	118	371	348	490	460
Total other comprehensive income (loss) before income taxes	1,791	(11,938)	2,633	(14,645)	12,026	(55,508)
Income tax benefit (expense) related to items of other comprehensive income (loss):						
Unrecognized pension and post-retirement benefit costs	(228)	(134)	(6)	(756)	(2,536)	14,456
Net unrealized losses (gains) on marketable securities	(435)	2,459	(757)	3,340	(1,269)	3,469
Losses on cash flow hedges	(165)	(46)	(293)	(161)	(335)	(201)
Total income tax benefit (expense)	(828)	2,279	(1,056)	2,423	(4,140)	17,724
Other comprehensive income (loss), net of tax	963	(9,659)	1,577	(12,222)	7,886	(37,784)
Comprehensive income	$75,599	$47,081	$92,689	$69,048	$99,646	$47,727

See accompanying notes to financial statements.

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EL PASO ELECTRIC COMPANY
STATEMENTS OF CASH FLOWS
(Unaudited)
(In thousands)

	Nine Months Ended September 30,	
	2016	2015
Cash flows from operating activities:		
Net income	$91,112	$81,270
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization of electric plant in service	63,097	67,080
Amortization of nuclear fuel	33,088	32,864
Deferred income taxes, net	48,457	32,090
Allowance for equity funds used during construction	(5,867)	(8,417)
Other amortization and accretion	12,102	13,273
Gain on sale of property, plant and equipment	(545)	(587)
Net gains on sale of decommissioning trust funds	(5,570)	(7,887)
Other operating activities	871	387
Change in:		
Accounts receivable	(46,371)	(33,156)
Inventories	(16)	(3,226)
Net over-collection (under-collection) of fuel revenues	(11,766)	10,934
Prepayments and other	(4,467)	(5,401)
Accounts payable	6,994	(14,397)
Taxes accrued	4,560	8,747
Interest accrued	6,700	4,078
Other current liabilities	1,218	2,005
Deferred charges and credits	(16,817)	(3,227)
Net cash provided by operating activities	176,780	176,430
Cash flows from investing activities:		
Cash additions to utility property, plant and equipment	(168,830)	(211,516)
Cash additions to nuclear fuel	(29,929)	(30,483)
Capitalized interest and AFUDC:		
Utility property, plant and equipment	(10,031)	(13,782)
Nuclear fuel	(3,738)	(3,758)
Allowance for equity funds used during construction	5,867	8,417
Decommissioning trust funds:		
Purchases, including funding of $3.4 million	(66,463)	(70,016)
Sales and maturities	60,165	63,776
Proceeds from sale of property, plant and equipment	3,251	644
Other investing activities	3,383	(627)
Net cash used for investing activities	(206,325)	(257,345)
Cash flows from financing activities:		
Dividends paid	(37,021)	(35,138)
Borrowings under the revolving credit facility:		
Proceeds	269,977	266,779
Payments	(356,523)	(162,618)
Payment on maturing RGRT senior notes	—	(15,000)

Proceeds from issuance of senior notes	157,052	—
Other financing activities	(2,045)	(1,039)
Net cash provided by financing activities	31,440	52,984
Net increase (decrease) in cash and cash equivalents	1,895	(27,931)
Cash and cash equivalents at beginning of period	8,149	40,504
Cash and cash equivalents at end of period	$10,044	$12,573

See accompanying notes to financial statements.

EL PASO ELECTRIC COMPANY
NOTES TO FINANCIAL STATEMENTS
(Unaudited)

A. Principles of Preparation

These condensed financial statements should be read in conjunction with the financial statements and notes thereto in the Annual Report of El Paso Electric Company on Form 10-K for the fiscal year ended December 31, 2015 (the "2015 Form 10-K"). Capitalized terms used in this report and not defined herein have the meaning ascribed to such terms in the 2015 Form 10-K. In the opinion of the Company's management, the accompanying financial statements contain all adjustments necessary to present fairly the financial position of the Company at September 30, 2016 and December 31, 2015; the results of its operations and comprehensive operations for the three, nine and twelve months ended September 30, 2016 and 2015; and its cash flows for the nine months ended September 30, 2016 and 2015. The results of operations and comprehensive operations for the three and nine months ended September 30, 2016 and the cash flows for the nine months ended September 30, 2016 are not necessarily indicative of the results to be expected for the full calendar year.

Pursuant to the rules and regulations of the Securities and Exchange Commission (the "SEC"), certain financial information has been condensed and certain footnote disclosures have been omitted. Such information and disclosures are normally included in financial statements prepared in accordance with generally accepted accounting principles.

Use of Estimates. The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. The Company evaluates its estimates on an on-going basis, including those related to depreciation, unbilled revenue, income taxes, fuel costs, pension and other post-retirement obligations and asset retirement obligations ("ARO"). Actual results could differ from those estimates.

Revenues. Revenues related to the sale of electricity are generally recorded when service is provided or electricity is delivered to customers. The billing of electricity sales to retail customers is based on the reading of their meters, which occurs on a systematic basis throughout the month. Unbilled revenues are recorded for estimated amounts of energy delivered in the period following the customer's billing cycle to the end of the month. Unbilled revenues are estimated based on monthly generation volumes and by applying an average revenue/kWh to the number of estimated kWhs delivered but not billed. Accounts receivable included accrued unbilled revenues of $30.3 million at September 30, 2016 and $21.7 million at December 31, 2015. The Company presents revenues net of sales taxes in its statements of operations.

Depreciation. The Company routinely evaluates the depreciable service lives, cost of removal and salvage values of its property, plant and equipment. Based, in part, upon a 2014 study performed for the Company, the Company modified certain salvage values related to both interim and final removal costs and service lives which were approved by the Company's regulators in 2016. The effect of the change in these estimates resulted in reducing depreciation expense approximately $7.4 million for the nine months ended September 30, 2016. The Company expects that the 2016 annual reduction to depreciation expense to approximate $9.5 million.

Income Taxes. The Company accounts for federal and state income taxes under the asset and liability method of accounting for income taxes. Deferred income taxes are recognized for the estimated future tax consequences of "temporary differences" by applying enacted statutory tax rates for each taxable jurisdiction applicable to future years to differences between the financial statement carrying amounts and the tax basis of existing assets and liabilities. Historically, certain temporary differences are accorded flow-through treatment by the Company's regulators and impact the Company's effective tax rate. The Financial Accounting Standards Board ("FASB") guidance requires that rate-regulated companies record deferred income taxes for temporary differences accorded flow-through treatment at the direction of the regulatory commission. The resulting deferred tax assets and liabilities are recorded at the expected cash flow to be reflected in future rates. Because the Company's regulators have consistently permitted the recovery of tax effects previously flowed-through earnings, the Company has recorded regulatory liabilities and assets offsetting such deferred tax assets and liabilities. During the third quarter of 2016, the Company changed its

accounting for state income taxes from the flow-through method to the normalization method in accordance with the Company's regulators in its most recent final orders from the Public Utility Commission of Texas ("PUCT") and the New Mexico Public Regulation Commission ("NMPRC"). Accordingly, the Company recorded deferred state income tax expense as required by normalization, retroactive to January 2016 as provided in the final orders. See Note F for further discussion. The effect on deferred tax assets and liabilities of a change in tax rate is recognized in income in the period that includes the enactment date. The Company recognizes tax assets and liabilities for uncertain tax positions in accordance with the recognition and measurement criteria of the FASB guidance for uncertainty in income taxes. See Note F.

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EL PASO ELECTRIC COMPANY
NOTES TO FINANCIAL STATEMENTS
(Unaudited)

Supplemental Cash Flow Disclosures (in thousands)

	Nine Months Ended September 30,	
	2016	2015
Cash paid (received) for:		
Interest on long-term debt and borrowings under the revolving credit facility	$46,867	$41,406
Income tax paid (refunded), net	3,337	(272)
Non-cash investing and financing activities:		
Sale of Interest in Four Corners Generating Station (a)	27,720	—
Changes in accrued plant additions	4,277	(13,150)
Grants of restricted shares of common stock	1,236	1,106

(a) The Company sold its interest in the Four Corners Generating Station ("Four Corners") for approximately $32.0 million based on the book value as defined in the asset purchase agreement entered into by the Company and Arizona Public Service Company ("APS") on February 17, 2015 (the "Purchase and Sale Agreement"). The sales price was adjusted downward by $7.0 million and $19.5 million, respectively, to reflect APS assumption of the Company's obligation to pay for future plant decommissioning and mine reclamation expense. The sales price was also adjusted downward by approximately $1.3 million for closing adjustments and other assets and liabilities assumed by APS. At the closing of the sale, the Company received approximately $4.2 million in cash, subject to post-closing adjustments. Subsequently, the Company recorded post-closing adjustments to reflect adjustments to estimated capital expenditures and other assets and liabilities assumed by APS through July 6, 2016, which resulted in a $1.6 million refund due to APS.

New Accounting Standards. In April 2015, the FASB issued Accounting Standards Update ("ASU") 2015-03, Interest - Imputation of Interest (Topic 715) to simplify the presentation of debt issuance costs. ASU 2015-03 requires that debt issuance costs related to a recognized debt liability be presented in the balance sheet as a direct deduction from the carrying amount of that debt liability, consistent with debt discounts. The recognition and measurement guidance for debt issuance costs are not affected by this ASU. ASU 2015-03 is effective for financial statements issued for fiscal years beginning after December 15, 2015, and interim periods within those fiscal years. In August 2015, the FASB issued ASU 2015-15, Interest - Imputation of Interest (Subtopic 835-30), to provide further clarification to ASU 2015-03 as it relates to the presentation and subsequent measurement of debt issuance costs associated with line of credit arrangements. The Company implemented ASU 2015-03 and ASU 2015-15 in the first quarter of 2016, retrospectively to all prior periods presented in the Company's Balance Sheet. The implementation of ASU 2015-03 did not have an impact on the Company's results of operations. See Note J.

In November 2015, the FASB issued ASU 2015-17, Balance Sheet Classification of Deferred Taxes to simplify the presentation of deferred income taxes. ASU 2015-17 requires that deferred tax liabilities and assets be classified as noncurrent in a classified statement of financial position. ASU 2015-17 can be applied prospectively or retrospectively and is effective for financial statements issued for annual periods beginning after December 15, 2016 and interim periods within those annual periods and early adoption is permitted. The Company elected to early adopt ASU 2015-17 retrospectively in the first quarter of 2016 in the Company's Balance Sheet. The implementation of ASU 2015-17 did not have an impact on the Company's results of operations. See Note F.

In May 2014, the FASB issued ASU 2014-09, Revenue from Contracts with Customers (Topic 606) to provide a framework that replaces the existing revenue recognition guidance. ASU 2014-09 is the result of a joint effort by the FASB and the International Accounting Standards Board intended to clarify the principles for recognizing revenue and to develop a common revenue standard for U.S. Generally Accepted Accounting Principles ("GAAP") and

International Financial Reporting Standards. ASU 2014-09 provides that an entity should recognize the amount of revenue to which it expects to be entitled for the transfer of promised goods or services to customers. ASU 2014-09 was originally intended to be effective for annual periods and interim periods within that reporting period beginning after December 15, 2016, for public business entities. In August 2015, FASB issued ASU 2015-14 to defer the effective date of ASU 2014-09 for all entities by one year. Public business entities will apply the guidance in ASU 2014-09 to annual reporting periods beginning after December 15, 2017 and interim periods within that reporting period. In March 2016, the FASB issued ASU 2016-08 to clarify the implementation guidance on principal versus agent consideration. In April 2016, the FASB issued ASU 2016-10 to clarify the implementation guidance on identifying performance obligations and licensing. In May

2016, the FASB issued ASU 2016-11, which rescinds certain SEC Staff Observer comments that are codified in FASB ASC Topic 605 (Revenue Recognition), effective upon adoption of Topic 606. In May 2016, the FASB issued ASU 2016-12, which makes narrow-scope amendments to ASU 2014-09, and provides practical expedients to simplify the transition to the new standard and to clarify certain aspects of the standard. Early adoption of ASU 2014-09 is permitted after December 15, 2016. The Company has not selected a transition method and is currently assessing the future impact of this ASU.

In January 2016, the FASB issued ASU 2016-01, Financial Instruments-Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Liabilities to enhance the reporting model for financial instruments by addressing certain aspects of recognition, measurement, presentation, and disclosure. ASU 2016-01 generally requires entities to measure equity investments that do not result in consolidation and are not accounted for under the equity method at fair value and recognize any changes in fair value in net income. The guidance for classifying and measuring investments in debt securities and loans is not changed by this ASU, but requires entities to record changes in other comprehensive income. Financial assets and financial liabilities must be separately presented by measurement category on the balance sheet or in the accompanying notes to the financial statements. ASU 2016-01 clarifies the need for a valuation allowance on a deferred tax asset related to available-for-sale securities in combination with the entity's other deferred tax assets. The standard includes a requirement that businesses must report changes in the fair value of their own liabilities in other comprehensive income instead of earnings, and this is the only provision of the update for which the FASB is permitting early adoption. The remaining provisions of this ASU become effective for public companies for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The Company is currently assessing the future impact of this ASU.

In February 2016, the FASB issued ASU 2016-02, Leases (Topic 842) to increase transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet and requiring qualitative and quantitative disclosures on leasing agreements. ASU 2016-02 maintains a distinction between finance leases and operating leases similar to the distinction under previous leases guidance for capital leases and operating leases. The impact of leases reported in the Company's operating results and statement of cash flows are expected to be similar to previous GAAP. ASU 2016-02 requires the recognition in the statement of financial position, by the lessee, of a liability to make lease payments (the lease liability) and a right-of-use asset representing its right to use the underlying asset for the lease term. How leases are recorded in regard to financial position represents a significant change from previous GAAP. The lessee is permitted to make an accounting policy election to not recognize lease assets and lease liabilities for short-term leases. Implementation of the standard for public companies will be required for annual reporting periods beginning after December 15, 2018 and interim periods within that reporting period. Early adoption of ASU 2016-02 is permitted for all entities. Adoption of the new lease accounting standard will require the Company to apply the new standard to the earliest period using a modified retrospective approach. The Company is currently assessing the future impact of this ASU.

In March 2016, the FASB issued ASU 2016-09, Compensation – Stock Compensation (Topic 718) Improvements to Employee Share-Based Payment Accounting to simplify the accounting for share-based payment transactions, including the income tax consequences, classification of awards either as equity or liabilities, and classification on the statements of cash flows. This ASU is effective for annual periods beginning after December 15, 2016, and interim periods within those annual periods. Early adoption is permitted. The Company is currently assessing the future impact of this ASU.

In June 2016, the FASB issued ASU 2016-13, Financial Instruments - Credit Losses (Topic 326). ASU 2016-13 significantly changes how companies measure and recognize credit impairment for many financial assets. The new current expected credit loss model will require companies to immediately recognize an estimate of credit losses expected to occur over the remaining life of the financial assets that are in the scope of the standard. The ASU also makes targeted amendments to the current impairment model for available-for-sale debt securities. For public business

entities, the provisions of ASU 2016-13 are effective for fiscal years and interim periods within that reporting period beginning after December 15, 2019. Early implementation is permitted as of the fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. ASU 2016-13 will be applied in a modified-retrospective approach through a cumulative-effect adjustment to retained earnings as of the beginning of the first reporting period in which the guidance is implemented. The Company is currently assessing the future impact of this ASU.

In August 2016, the FASB issued ASU 2016-15, Statement of Cash Flows (Topic 230) Classification of Certain Cash Receipts and Cash Payments to reduce diversity in practice in how certain cash receipts and cash payments are classified in the statement of cash flows. The new guidance addresses the following classification issues: debt prepayment or debt extinguishment costs; settlement of zero-coupon bonds; contingent consideration payments made after a business combination; proceeds from the settlement of insurance claims; proceeds from the settlement of corporate-owned life insurance policies, including bank-owned life insurance policies; distributions received from equity method investees; beneficial interests in securitization transactions; and

separately identifiable cash flows and application of the predominance principle. For public business entities, the provisions of ASU 2016-15 are effective for fiscal years and interim periods within that reporting period beginning after December 15, 2017. Early adoption is permitted, including adoption in an interim period. If an entity elects early adoption of ASU 2016-15 in an interim period, adjustments should be reflected as of the beginning of the fiscal year that includes that interim period. An entity that elects early adoption must adopt all of the amendments in the same period. ASU 2016-15 will be applied using a retrospective transition method to each period presented. If it is impracticable to apply ASU 2016-15 retrospectively for some of the issues, the amendments for those issues may be applied prospectively as of the earliest date practicable. The Company is currently assessing the future impact of this ASU.

Reclassification. Certain amounts in the financial statements for 2015 have been reclassified to conform to the 2016 presentation. The Company implemented ASU 2015-03 and ASU 2015-17 in the first quarter of 2016, retrospectively to all periods presented in the Company's financial statements. See Note F and Note J, respectively.

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B. Accumulated Other Comprehensive Income (Loss)

Changes in Accumulated Other Comprehensive Income (Loss) (net of tax) by component are presented below (in thousands):

	Three Months Ended September 30, 2016				Three Months Ended September 30, 2015			
	Unrecognized Pension and Post-retirement Benefit Costs	Net Unrealized Gains (Losses) on Marketable Securities	Net Losses on Cash Flow Hedges	Accumulated Other Comprehensive Income (Loss)	Unrecognized Pension and Post-retirement Benefit Costs	Net Unrealized Gains (Losses) on Marketable Securities	Net Losses on Cash Flow Hedges	Accumulated Other Comprehensive Income (Loss)
Balance at beginning of period	$(30,532)	$ 28,925	$(11,693)	$ (13,300)	$(34,331)	$ 35,726	$(11,959)	$ (10,564)
Other comprehensive income (loss) before reclassifications	—	3,493	—	3,493	—	(6,485)	—	(6,485)
Amounts reclassified from accumulated other comprehensive income (loss)	(804)	(1,687)	(39)	(2,530)	226	(3,472)	72	(3,174)
Balance at end of period	$(31,336)	$ 30,731	$(11,732)	$ (12,337)	$(34,105)	$ 25,769	$(11,887)	$ (20,223)

	Nine Months Ended September 30, 2016				Nine Months Ended September 30, 2015			
	Unrecognized Pension and Post-retirement Benefit Costs	Net Unrealized Gains (Losses) on Marketable Securities	Net Losses on Cash Flow Hedges	Accumulated Other Comprehensive Income (Loss)	Unrecognized Pension and Post-retirement Benefit Costs	Net Unrealized Gains (Losses) on Marketable Securities	Net Losses on Cash Flow Hedges	Accumulated Other Comprehensive Income (Loss)
Balance at beginning of period	$(29,869)	$ 27,765	$(11,810)	$ (13,914)	$(34,884)	$ 38,957	$(12,074)	$ (8,001)
Other comprehensive income (loss) before reclassifications	—	7,459	—	7,459	—	(6,854)	—	(6,854)

Amounts reclassified from accumulated other comprehensive income (loss)	(1,467)	(4,493)	78	(5,882)	779	(6,334)	187	(5,368)
Balance at end of period	$(31,336)	$ 30,731	$(11,732)	$ (12,337)	$(34,105)	$ 25,769	$(11,887)	$ (20,223)

	Twelve Months Ended September 30, 2016				Twelve Months Ended September 30, 2015			
	Unrecognized Pension and Post-retirement Benefit Costs	Net Unrealized Gains (Losses) on Marketable Securities	Net Losses on Cash Flow Hedges	Accumulated Other Comprehensive Income (Loss)	Unrecognized Pension and Post-retirement Benefit Costs	Net Unrealized Gains (Losses) on Marketable Securities	Net Losses on Cash Flow Hedges	Accumulated Other Comprehensive Income (Loss)
Balance at beginning of period	$(34,105)	$ 25,769	$(11,887)	$ (20,223)	$(9,818)	$ 39,525	$(12,146)	$ 17,561
Other comprehensive income (loss) before reclassifications	3,777	12,058	—	15,835	(24,775)	(4,537)	—	(29,312)
Amounts reclassified from accumulated other comprehensive income (loss)	(1,008)	(7,096)	155	(7,949)	488	(9,219)	259	(8,472)
Balance at end of period	$(31,336)	$ 30,731	$(11,732)	$ (12,337)	$(34,105)	$ 25,769	$(11,887)	$ (20,223)

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Amounts reclassified from Accumulated Other Comprehensive Income (Loss) for the three, nine and twelve months ended September 30, 2016 and 2015 are as follows (in thousands):

Details about Accumulated Other Comprehensive Income (Loss) Components	Three Months Ended September 30,		Nine Months Ended September 30,		Twelve Months Ended September 30,		Affected Line Item in the Statement of Operations
	2016	2015	2016	2015	2016	2015	
Amortization of pension and post-retirement benefit costs:							
Prior service benefit	$1,663	$1,606	$4,993	$4,931	$ 6,636	$ 6,996	(a)
Net loss	(1,087)	(1,966)	(3,532)	(6,466)	(5,688)	(8,081)	(a)
	576	(360)	1,461	(1,535)	948	(1,085)	(a)
Income tax effect	228	134	6	756	60	597	Income tax expense
	804	(226)	1,467	(779)	1,008	(488)	(a)
Marketable securities:							
Net realized gain on sale of securities	2,072	4,324	5,570	7,887	8,797	11,446	Investment and interest income, net
	2,072	4,324	5,570	7,887	8,797	11,446	Income before income taxes
Income tax effect	(385)	(852)	(1,077)	(1,553)	(1,701)	(2,227)	Income tax expense
	1,687	3,472	4,493	6,334	7,096	9,219	Net income

Loss on cash flow hedge:							
Amortization of loss	(126)	(118)	(371)	(348)	(490)	(460)	Interest on long-term debt and revolving credit facility
	(126)	(118)	(371)	(348)	(490)	(460)	Income before income taxes
Income tax effect	165	46	293	161	335	201	Income tax expense
	39	(72)	(78)	(187)	(155)	(259)	Net income
Total reclassifications	$2,530	$3,174	$5,882	$5,368	$ 7,949	$ 8,472	

(a) These items are included in the computation of net periodic benefit cost. See Note I, Employee Benefits, for additional information.

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C. Regulation
General
The rates and services of the Company are regulated by incorporated municipalities in Texas, the PUCT, the NMPRC, and the Federal Energy Regulatory Commission ("FERC"). Municipal orders, ordinances and other agreements regarding rates and services adopted by Texas municipalities are subject to review and approval by the PUCT. The FERC has jurisdiction over the Company's wholesale (sales for resale) transactions, transmission service and compliance with federally-mandated reliability standards. The decisions of the PUCT, the NMPRC and the FERC are subject to judicial review.
Texas Regulatory Matters
2015 Texas Retail Rate Case Filing. On August 10, 2015, the Company filed with the City of El Paso, other municipalities incorporated in its Texas service territory, and the PUCT in Docket No. 44941, a request for an annual increase in non-fuel base revenues of approximately $71.5 million. On January 15, 2016, the Company filed its rebuttal testimony modifying the requested increase to $63.3 million.
On August 25, 2016, the PUCT issued its final order in Docket No. 44941 (the "PUCT Final Order"), as proposed, approving the Joint Motion to Implement Uncontested Amended and Restated Stipulation and Agreement (the "Unopposed Settlement") that was filed with the PUCT on July 21, 2016, which was unopposed by the parties to the rate case. The PUCT Final Order provides for the following: (i) an annual non-fuel rate increase of $37 million, lower annual depreciation expense of approximately $8.5 million, a return on equity of 9.7% for AFUDC purposes, and inclusion of substantially all new plant in service in rate base; (ii) an additional annual non-fuel base rate increase of $3.7 million related to Four Corners costs, which will be collected through a surcharge that terminates on July 12, 2017 and applies to consumption on and after January 12, 2016; (iii) removal of the separate rate treatment for residential customers with solar systems; (iv) recovery of $3.1 million in rate case expenses through a separate surcharge; and (v) recovery of revenues associated with the relate back of rates to consumption on and after January 12, 2016 through March 31, 2016 (aggregating $4.8 million) through a separate surcharge, all as specified in the Unopposed Settlement. The costs of serving residential customers with solar generation will be addressed in a future proceeding.
Interim rates associated with the annual non-fuel rate increase of $37 million became effective on April 1, 2016. The additional surcharges associated with the incremental Four Corners costs, rate case expenses and the relate back of rates to consumption on and after January 12, 2016 through March 31, 2016 were implemented on October 1, 2016. Given the uncertainties regarding the ultimate resolution of the rate case, the Company did not recognize the impacts of the Unopposed Settlement in the Statements of Operations until it received the PUCT Final Order on August 25, 2016. Accordingly, operating revenues increased approximately $34.8 million, depreciation decreased approximately $7.4 million, and other expenses, net, increased approximately $1.9 million for an aggregate increase in income before income taxes of $40.3 million and an increase in net income of $23.3 million in the third quarter of 2016 to reflect the effects of the PUCT Final Order.
Energy Efficiency Cost Recovery Factor. On May 1, 2015, the Company filed its annual application to establish its energy efficiency cost recovery factor for 2016. In addition to projected energy efficiency costs for 2016 and a true-up to prior year actual costs, the Company requested approval of a $1.0 million bonus for the 2014 energy efficiency program results in accordance with PUCT rules. This case was assigned PUCT Docket No. 44677. A stipulation and settlement agreement was filed September 24, 2015 and the PUCT approved the settlement on November 5, 2015. The settlement approved by the PUCT includes a performance bonus of $1.0 million. The Company recorded the performance bonus as operating revenue in the fourth quarter of 2015.
On April 29, 2016, the Company filed its annual application to establish its energy efficiency cost recovery factor for 2017. In addition to projected energy efficiency costs for 2017 and true-up to prior year actual costs, the Company requested approval of a $668 thousand bonus for the 2015 energy efficiency program results in accordance with

PUCT rules. This case was assigned PUCT Docket No. 45885. Parties in the proceeding, including PUCT staff and the City of El Paso, have filed a settlement in the case that approves the Company's filed proposal with a reduction to the 2015 program bonus of $155 thousand. The PUCT approved the settlement on October 28, 2016. The settlement approved by the PUCT includes a performance bonus of $0.5 million. The Company recorded the performance bonus as operating revenue in the third quarter of 2016.

Fuel and Purchased Power Costs. The Company's actual fuel costs, including purchased power energy costs, are recovered from customers through a fixed fuel factor. The PUCT has adopted a fuel cost recovery rule (the "Texas Fuel Rule") that allows the Company to seek periodic adjustments to its fixed fuel factor. The Company can seek to revise its fixed fuel factor based upon

the approved formula at least four months after its last revision except in the month of December. The Texas Fuel Rule requires the Company to request to refund fuel costs in any month when the over-recovery balance exceeds a threshold material amount and it expects fuel costs to continue to be materially over-recovered. The Texas Fuel Rule also permits the Company to seek to surcharge fuel under-recoveries in any month the balance exceeds a threshold material amount and it expects fuel cost recovery to continue to be materially under-recovered. Fuel over- and under-recoveries are considered material when they exceed 4% of the previous twelve months' fuel costs. All such fuel revenue and expense activities are subject to periodic final review by the PUCT in fuel reconciliation proceedings.

On April 15, 2015, the Company filed a request, which was assigned PUCT Docket No. 44633, to reduce its fixed fuel factor by approximately 24% to reflect reduced fuel expenses primarily related to a reduction in the price of natural gas used to generate power. The over-recovered balance was below the PUCT's materiality threshold. The reduction in the fixed fuel factor was effective on an interim basis May 1, 2015 and approved by the PUCT on May 20, 2015. As of September 30, 2016, the Company had under-recovered fuel costs in the amount of $8.9 million for the Texas jurisdiction.

Fuel Reconciliation Proceeding. On September 27, 2016, the Company filed an application with the PUCT, designated as PUCT Docket No. 46308, to reconcile $436.6 million of fuel and purchased power expenses incurred during the period of April 1, 2013 through March 31, 2016.

Montana Power Station Approvals. The Company has received a Certificate of Convenience and Necessity ("CCN") from the PUCT to construct four natural gas fired generating units at Montana Power Station ("MPS") in El Paso County, Texas. The Company also obtained air permits from the Texas Commission on Environmental Quality (the "TCEQ") and the U.S. Environmental Protection Agency (the "EPA"). MPS Units 1 and 2 and associated transmission lines and common facilities were completed and placed into service in March 2015. MPS Units 3 and 4 were completed and placed into service on May 3, 2016 and September 15, 2016, respectively.

Community Solar. On June 8, 2015, the Company filed a petition with the PUCT to initiate a community solar program to include construction and ownership of a 3 MW solar photovoltaic system located at MPS. Participation will be on a voluntary basis, and customers will contract for a set capacity (kW) amount and receive all energy produced. This case was assigned PUCT Docket No. 44800. The Company filed a settlement agreement among all parties on July 1, 2016 approving the program, and the PUCT approved the settlement agreement and program on September 1, 2016.

Four Corners Generating Station. On February 17, 2015, the Company and APS entered the Purchase and Sale Agreement providing for purchase by APS of the Company's interests in Four Corners. The Four Corners transaction closed on July 6, 2016. See Note D for further details on the sale of Four Corners.

On June 10, 2015, the Company filed an application in Texas requesting reasonableness and public interest findings and certain rate and accounting findings related to the Purchase and Sale Agreement. This case was assigned PUCT Docket No. 44805. Subsequent to the filing of the application, the case has been subject to numerous procedural matters, including a March 23, 2016 order in which the PUCT determined not to dismiss the reasonableness and public interest issues in this docket but to consider the requested rate and accounting findings, including mine reclamation costs, in the Company's next rate case, which is expected to be filed in the first half of 2017. The procedural schedule related to the public interest issues called for a hearing to be held on October 6-7, 2016. However, on September 1, 2016, a motion by parties in the proceeding to suspend the procedural schedule in order to pursue settlement was approved by the PUCT.

At September 30, 2016, the regulatory asset associated with the Four Corners mine reclamation costs for our Texas jurisdiction approximated $7.5 million. The Company currently continues to recover its mine reclamation costs in Texas under previous orders and decisions of the PUCT. If any future determinations made by our regulators result in changes to how existing regulatory assets or previously incurred costs for Four Corners are recovered in rates, any

such changes would be recognized only when it becomes probable future cash flows will change as a result of such regulatory actions.

Other Required Approvals. The Company has obtained other required approvals for tariffs and approvals as required by the Public Utility Regulatory Act (the "PURA") and the PUCT.

New Mexico Regulatory Matters

2015 New Mexico Rate Case Filing. On May 11, 2015, the Company filed with the NMPRC in Case No. 15-00127-UT, for an annual increase in non-fuel base rates of approximately $8.6 million or 7.1%. Subsequently, the Company reduced its requested increase in non-fuel base rates to approximately $6.4 million. On June 8, 2016, the NMPRC issued its final order approving an

annual increase in non-fuel base rates of approximately $1.1 million and a decrease in the Company's allowed return on equity to 9.48%. The final order concludes that all of the Company's new plant in service was reasonable and necessary and therefore would be recoverable in rate base. The Company's rates were approved by the NMPRC effective July 1, 2016 and implemented at such time.

Fuel and Purchased Power Costs. On January 8, 2014, the NMPRC approved the continuation of the Fuel and Purchased Power Cost Adjustment Clause (the "FPPCAC") without modification in NMPRC Case No. 13-00380-UT. Historically, fuel and purchased power costs were recovered through base rates and a FPPCAC that accounts for changes in the costs of fuel relative to the amount included in base rates. Effective July 1, 2016, with the implementation of the final order of Case No. 15-00127-UT, fuel and purchased power costs will no longer be recovered through base rates but will be completely recovered through the FPPCAC. Fuel and purchased power costs are reconciled to actual costs on a monthly basis and recovered or refunded to customers the second succeeding month. The Company recovers costs related to Palo Verde Unit 3 capacity and energy in New Mexico through the FPPCAC as purchased power using a proxy market price approved in Case No. 13-00380-UT. At September 30, 2016, the Company had a net fuel over-recovery balance of $1.3 million in New Mexico.

Montana Power Station Approvals. The Company has received a CCN from the NMPRC to construct four units at MPS and the associated transmission lines. The Company also obtained all necessary air permits from the TCEQ and the EPA. A final order in NMPRC Case No. 13-00297-UT approving the CCN for MPS Units 3 and 4 was issued on June 11, 2014. MPS Units 1 and 2 were completed and placed into service in March 2015. MPS Units 3 and 4 were completed and placed into service on May 3, 2016 and September 15, 2016, respectively.

Four Corners. On February 17, 2015, the Company and APS entered into the Purchase and Sale Agreement providing for the purchase by APS of the Company's interests in Four Corners. On April 27, 2015, the Company filed an application in NMPRC Case No. 15-00109-UT requesting all necessary regulatory approvals to sell its ownership interest in Four Corners. On February 2, 2016, the Company filed a joint stipulation with the NMPRC reflecting a settlement agreement among the NMPRC's Utility Division Staff, the Company and the New Mexico Attorney General proposing approval of abandonment and sale of its seven percent minority ownership interest in Four Corners Units 4 and 5 and common facilities to APS. A hearing in the case was held on February 16, 2016, and the Hearing Examiner issued a Certification of Stipulation on April 22, 2016 recommending approval of the joint stipulation without modification. On June 15, 2016, the NMPRC issued its final order approving the stipulation. See Note D for further details on the sale of Four Corners.

5 MW Holloman Air Force Base ("HAFB") Facility CCN. On June 15, 2015, the Company filed a petition with the NMPRC requesting CCN authorization to construct a 5 MW solar-powered generation facility to be located at HAFB in the Company's service territory in New Mexico. The new facility will be a dedicated Company-owned resource serving HAFB. This case was assigned NMPRC Case No. 15-00185-UT. On October 7, 2015, the NMPRC issued a final order accepting the Hearing Examiner’s Recommended Decision to approve the CCN, as modified. The Company and HAFB negotiated a special retail contract, which includes power sales agreement for the facility, to replace the existing load retention agreement and requested approval in NMPRC Case No. 16-00224-UT. On October 5, 2016 the new agreement was approved by the NMPRC. Construction of the solar generation facility will begin in the fourth quarter of 2016 and is expected to be completed in the second quarter of 2017.

Issuance of Long-Term Debt and Guarantee of Debt. On October 7, 2015, the Company received approval in NMPRC Case No. 15-00280-UT to issue up to $310 million in new long-term debt; and to guarantee the issuance of up to $65 million of new debt by Rio Grande Resources Trust ("RGRT") to finance future purchases of nuclear fuel and to refinance existing nuclear fuel debt obligations. This approval supersedes prior approvals. Under this authorization, on March 24, 2016, the Company issued $150 million in aggregate principal amount of 5.00% Senior Notes due December 1, 2044. The net proceeds from the issuance of these senior notes, after deducting the underwriters' commission, were $158.1 million. These proceeds include accrued interest of $2.4 million and a $7.1 million premium

before expenses. These senior notes constitute an additional issuance of the Company's 5.00% Senior Notes due 2044, of which $150 million was previously issued on December 1, 2014, for a total principal amount outstanding of $300 million.

Other Required Approvals. The Company has obtained other required approvals for other tariffs, securities transactions, recovery of energy efficiency costs through a base rate rider and other approvals as required by the NMPRC.

Federal Regulatory Matters

Four Corners. On June 26, 2015, APS filed an application requesting authorization from FERC to purchase 100% of the Company's ownership interest in Units 4 and 5 of Four Corners and the associated transmission interconnection facilities and rights. On December 22, 2015, FERC issued an order approving the proposed transaction. The Four Corners transaction closed on July 6, 2016. See Note D for further details on the sale of Four Corners.

Public Service Company of New Mexico ("PNM") Transmission Rate Case. On December 31, 2012, PNM filed with FERC to change its method of transmission rate recovery for its transmission delivery services from stated rates to formula rates. The Company takes transmission service from PNM and is among the PNM transmission customers affected by PNM's shift to formula rates. On March 1, 2013, the FERC issued an order rejecting in part PNM's filing, and establishing settlement judge and hearing procedures. On March 20, 2015, PNM filed with FERC a settlement agreement and offer of settlement resolving all issues set for hearing in the proceeding. On March 25, 2015, the Chief Judge issued an order granting PNM's motion to implement the settled rates. On March 17, 2016, FERC issued an order approving the settlement.

Revolving Credit Facility; Issuance of Long-Term Debt and Guarantee of Debt. On October 19, 2015, the FERC issued an order in Docket No. ES15-66-000 approving the Company's filing to issue short-term debt under its existing revolving credit facility ("RCF") up to $400 million outstanding at any time, to issue up to $310 million in long-term debt, and to guarantee the issuance of up to $65 million of new long-term debt by RGRT to finance future nuclear fuel purchases. The authorization is effective from November 15, 2015 through November 15, 2017. This approval supersedes prior approvals. Under this authorization, on March 24, 2016, the Company issued $150 million in aggregate principal amount of 5.00% Senior Notes due December 1, 2044. The net proceeds from the issuance of these senior notes, after deducting the underwriters' commission, were $158.1 million. These proceeds include accrued interest of $2.4 million and a $7.1 million premium before expenses. These senior notes constitute an additional issuance of the Company's 5.00% Senior Notes due 2044, of which $150 million was previously issued on December 1, 2014, for a total principal amount outstanding of $300 million.

Other Required Approvals. The Company has obtained required approvals for rates and tariffs, securities transactions and other approvals as required by the FERC.

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D. Palo Verde and Four Corners

Spent Nuclear Fuel and Waste Disposal. Pursuant to the Nuclear Waste Policy Act of 1982, as amended in 1987 (the "NWPA"), the U.S. Department of Energy (the "DOE") is legally obligated to accept and dispose of all spent nuclear fuel and other high-level radioactive waste generated by all domestic power reactors by 1998. The DOE's obligations are reflected in a contract for Disposal of Spent Nuclear Fuel and/or High-Level Radioactive Waste (the "Standard Contract") with each nuclear power plant. The DOE failed to begin accepting spent nuclear fuel by 1998.

On December 19, 2012, APS, acting on behalf of itself and the Palo Verde Participants, filed a second breach of contract lawsuit against the DOE. This lawsuit sought to recover damages incurred due to the DOE's failure to accept Palo Verde's spent nuclear fuel for the period beginning January 1, 2007 through June 30, 2011. On August 18, 2014, APS and the DOE entered into a settlement agreement, stipulating to a dismissal of the lawsuit and payment of $57.4 million by the DOE to the Palo Verde Participants for certain specified costs incurred by Palo Verde during the period January 1, 2007 through June 30, 2011. On October 8, 2014, the Company received approximately $9.1 million, representing its share of the award, of which $7.9 million was credited to customers through the applicable fuel adjustment clauses.

On October 31, 2014, APS, acting on behalf of itself and the Palo Verde Participants, submitted to the government an additional request for reimbursement of spent nuclear fuel storage costs for the period July 1, 2011 through June 30, 2014. The accepted claim amount was $42.0 million. On June 1, 2015, the Company received approximately $6.6 million, representing its share of the award, of which $5.8 million was credited to customers through the applicable fuel adjustment clauses in March 2015. Thereafter, APS will file annual claims for the period July 1 of the then-previous year to June 30 of the then-current year.

On November 2, 2015, APS filed a $12.0 million claim for the period July 1, 2014 through June 30, 2015. In February 2016, the DOE notified APS of the approval of the claim. Funds related to this claim were received in the first quarter of 2016. The Company's share of this claim is approximately $1.9 million, of which $1.6 million was credited to customers through the applicable fuel adjustment clauses in March 2016.

On October 31, 2016, APS filed an $11.3 million claim for the period July 1, 2015 through June 30, 2016. The Company's share of this claim is approximately $1.8 million. Any reimbursement is anticipated to be received in the second quarter of 2017, and the majority will be credited to customers through the applicable fuel adjustment clauses.

Palo Verde Operations and Maintenance Expense. Included in other operations and maintenance expenses are expenses associated with Palo Verde as follows (in thousands):

	2016	2015
Three months ended September 30,	$21,123	$22,016
Nine months ended September 30,	67,514	67,702
Twelve months ended September 30,	97,451	98,884

Four Corners. On February 17, 2015, the Company and APS entered into the Purchase and Sale Agreement providing for the purchase by APS of the Company's interests in Four Corners. Four Corners continued to provide energy to serve the Company's native load up to the closing date. The Four Corners transaction closed on July 6, 2016. The sales price was $32.0 million based on the net book value as defined in the Purchase and Sale Agreement. The sales price was adjusted downward by $7.0 million and $19.5 million, respectively, to reflect APS's assumption of the Company's obligation to pay for future plant decommissioning and mine reclamation expenses. The sales price was also adjusted downward by approximately $1.3 million for estimated closing adjustments and other assets and liabilities assumed by APS. At the closing, the Company received approximately $4.2 million in cash, subject to post-closing adjustments. No significant gain or loss was recorded upon the closing of the sale. APS assumed responsibility for all capital expenditures made after July 6, 2016. In addition, APS will indemnify the Company against liabilities and costs related to the future operation of Four Corners. Subsequently, the Company recorded post-closing adjustments to reflect adjustments to estimated capital expenditures and other assets and liabilities assumed by APS through July 6, 2016, which resulted in a $1.6 million refund due to APS. See Note C for a discussion of regulatory filings associated with Four Corners.

E. Common Stock

Dividends. The Company paid $12.5 million and $11.9 million in quarterly cash dividends during the three months ended September 30, 2016 and 2015, respectively. The Company paid a total of $37.0 million and $49.0 million in quarterly cash dividends during the nine and twelve months ended September 30, 2016, respectively. The Company paid a total of $35.1 million and $46.4 million in quarterly cash dividends during the nine and twelve months ended September 30, 2015, respectively.

Basic and Diluted Earnings Per Share. The basic and diluted earnings per share are presented below (in thousands except for share data):

	Three Months Ended September 30,	
	2016	2015
Weighted average number of common shares outstanding:		
Basic number of common shares outstanding	40,363,819	40,289,010
Dilutive effect of unvested performance awards	62,123	40,519
Diluted number of common shares outstanding	40,425,942	40,329,529
Basic net income per common share:		
Net income	$74,636	$ 56,740
Income allocated to participating restricted stock	(232)	(184)
Net income available to common shareholders	$74,404	$ 56,556
Diluted net income per common share:		
Net income	$74,636	$ 56,740
Income reallocated to participating restricted stock	(232)	(184)
Net income available to common shareholders	$74,404	$ 56,556
Basic net income per common share:		
Distributed earnings	$0.310	$ 0.295
Undistributed earnings	1.530	1.105
Basic net income per common share	$1.840	$ 1.400
Diluted net income per common share:		
Distributed earnings	$0.310	$ 0.295
Undistributed earnings	1.530	1.105
Diluted net income per common share	$1.840	$ 1.400

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	Nine Months Ended September 30,	
	2016	2015
Weighted average number of common shares outstanding:		
Basic number of common shares outstanding	40,344,834	40,267,533
Dilutive effect of unvested performance awards	50,977	32,268
Diluted number of common shares outstanding	40,395,811	40,299,801
Basic net income per common share:		
Net income	$91,112	$ 81,270
Income allocated to participating restricted stock	(271)	(253)
Net income available to common shareholders	$90,841	$ 81,017
Diluted net income per common share:		
Net income	$91,112	$ 81,270
Income reallocated to participating restricted stock	(271)	(253)
Net income available to common shareholders	$90,841	$ 81,017
Basic net income per common share:		
Distributed earnings	$0.915	$ 0.870
Undistributed earnings	1.335	1.140
Basic net income per common share	$2.250	$ 2.010
Diluted net income per common share:		
Distributed earnings	$0.915	$ 0.870
Undistributed earnings	1.335	1.140
Diluted net income per common share	$2.250	$ 2.010

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EL PASO ELECTRIC COMPANY
NOTES TO FINANCIAL STATEMENTS
(Unaudited)

	Twelve Months Ended September 30,	
	2016	2015
Weighted average number of common shares outstanding:		
Basic number of common shares outstanding	40,332,835	40,255,439
Dilutive effect of unvested performance awards	47,608	24,201
Diluted number of common shares outstanding	40,380,443	40,279,640
Basic net income per common share:		
Net income	$ 91,760	$ 85,511
Income allocated to participating restricted stock	(264)	(265)
Net income available to common shareholders	$ 91,496	$ 85,246
Diluted net income per common share:		
Net income	$ 91,760	$ 85,511
Income reallocated to participating restricted stock	(264)	(265)
Net income available to common shareholders	$ 91,496	$ 85,246
Basic net income per common share:		
Distributed earnings	$ 1.21	$ 1.15
Undistributed earnings	1.06	0.97
Basic net income per common share	$ 2.27	$ 2.12
Diluted net income per common share:		
Distributed earnings	$ 1.21	$ 1.15
Undistributed earnings	1.06	0.97
Diluted net income per common share	$ 2.27	$ 2.12

The amount of restricted stock awards and performance shares at 100% performance level excluded from the calculation of the diluted number of common shares outstanding because their effect was antidilutive is presented below:

	Three Months Ended September 30,		Nine months ended September 30,		Twelve Months Ended September 30,	
	2016	2015	2016	2015	2016	2015
Restricted stock awards	57,633	65,076	53,285	60,647	50,854	60,742
Performance shares (a)	62,995	59,898	62,995	59,898	62,995	63,111

(a) Certain performance shares were excluded from the computation of diluted earnings per share as no payouts would have been required based upon performance at the end of each corresponding period.

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F. Income Taxes

The Company files income tax returns in the United States ("U.S.") federal jurisdiction and in the states of Texas, New Mexico and Arizona. The Company is no longer subject to tax examination by the taxing authorities in the federal and New Mexico jurisdictions for years prior to 2011. The Company is currently under audit in Texas for tax years 2007 through 2011. In June 2016, the Arizona Department of Revenue discontinued their audits for tax years 2009 through 2012. The discontinuance of the audits did not have a material impact on the Company's results of operations or financial position.

For the three months ended September 30, 2016 and 2015, the Company’s effective tax rate was 36.6% and 30.2%, respectively. For the nine months ended September 30, 2016 and 2015, the Company's effective tax rate was 36.1% and 30.2%, respectively. For the twelve months ended September 30, 2016 and 2015, the Company's effective tax rate was 35.8% and 30.4%, respectively. The Company's effective tax rate for all periods differs from the federal statutory tax rate of 35.0% primarily due to capital gains in the decommissioning trusts which are taxed at the federal rate of 20.0%, the allowance for equity funds used during construction ("AEFUDC"), state taxes and the issue discussed in the following paragraph.

In the third quarter of 2016, the Company changed its accounting for state income taxes from the flow-through method to the normalization method in accordance with the Company's regulators in its most recent final orders from the PUCT and the NMPRC. Under the flow-through method, the Company previously recorded deferred state income taxes and regulatory liabilities and assets offsetting such deferred state income taxes at the expected cash flow to be reflected in future rates. Upon implementation of normalization, the Company began amortizing the net regulatory asset for deferred state income taxes to deferred income tax expense over a 15 year period as allowed by the regulators. In the third quarter of 2016, the Company began recording deferred state income tax expense as required by normalization, retroactive to January 2016 as provided in the final orders. The impact of the change was additional deferred income tax expense of $2.8 million for the three months ended September 30, 2016.

In November 2015, the FASB issued new guidance (ASU 2015-17, Balance Sheet Classification of Deferred Taxes) to simplify the presentation of deferred income taxes. ASU 2015-17 requires that deferred tax liabilities and assets be classified as noncurrent in a classified statement of financial position. ASU 2015-17 can be applied prospectively or retrospectively and is effective for financial statements issued for annual periods beginning after December 15, 2016 and interim periods within those annual periods and early adoption is permitted. The Company elected to implement ASU 2015-17 on a retrospective basis for financial statements issued beginning March 31, 2016. The implementation of ASU 2015-17 did not have a material impact on the Company's results of operations. The impact of ASU 2015-17 on the Company's Balance Sheet was to reclassify $21.6 million of current deferred tax assets to long-term deferred tax liabilities at December 31, 2015.

FASB guidance prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. The Company recorded a reduction in the unrecognized tax position of $0.9 million in the three months ended September 30, 2016, and $0.1 million in the first quarter of 2015, related to transmission and distribution costs and other amounts deducted in prior year Texas franchise tax returns. The Company recorded a decrease of $0.3 million in the first quarter of 2016 related to tax credits taken and apportionment factors used in prior year Arizona income tax returns, which have been settled through audit. A reconciliation of the September 30, 2016 and 2015 amounts of unrecognized tax benefits are as follows (in thousands):

	2016	2015
Balance at January 1	$6,000	$5,200
Additions for tax position related to the current year	—	—
Reductions for tax positions related to the current year	—	—

Additions for tax positions of prior years	—	—
Reductions for tax positions	(1,200)	(100)
Balance at September 30	$4,800	$5,100

G. Commitments, Contingencies and Uncertainties

For a full discussion of commitments and contingencies, see Note K of the Notes to Financial Statements in the 2015 Form 10-K. In addition, see Notes C and D above and Notes C and E of the Notes to Financial Statements in the 2015 Form 10-K regarding matters related to wholesale power sales contracts and transmission contracts subject to regulation and Palo Verde, including decommissioning, spent nuclear fuel and waste disposal, and liability and insurance matters.

Power Purchase and Sale Contracts

To supplement its own generation and operating reserve requirements, and to meet required renewable portfolio standards, the Company engages in power purchase arrangements which may vary in duration and amount based on an evaluation of the Company's resource needs, the economics of the transactions, and specific renewable portfolio requirements. For a full discussion of power purchase and sale contracts that the Company has entered into with various counterparties, see Note K of the Notes to Financial Statements in the 2015 Form 10-K.

Environmental Matters

General. The Company is subject to extensive laws, regulations, and permit requirements with respect to air and greenhouse gas emissions, water discharges, soil and water quality, waste management and disposal, natural resources, and other environmental matters by federal, state, regional, tribal, and local authorities. Failure to comply with such laws, regulations, and requirements can result in actions by authorities or other third parties that might seek to impose on the Company administrative, civil, and/or criminal penalties or other sanctions. In addition, releases of pollutants or contaminants into the environment can result in costly cleanup liabilities. These laws, regulations, and requirements are subject to change through modification or reinterpretation, or the introduction of new laws and regulations and, as a result, the Company may face additional capital and operating costs to comply. For a more detailed discussion of certain key environmental issues, laws, and regulations facing the Company, see Note K of the Notes to Financial Statements in the 2015 Form 10-K.

Clean Air Interstate Rule/Cross State Air Pollution Rule. The EPA promulgated the Cross-State Air Pollution Rule ("CSAPR") in August 2011, which rule involves requirements to limit emissions of nitrogen oxides ("NOx") and sulfur dioxide ("SO2") from certain of the Company's power plants in Texas and/or purchase allowances representing other parties' emissions reductions. CSAPR was intended to replace the EPA's 2005 Clean Air Interstate Rule ("CAIR"). While the U.S. Court of Appeals for the District of Columbia Circuit ("D.C. Circuit") vacated CSAPR in August 2012 and allowed CAIR to stand until the EPA issued a proper replacement, on April 29, 2014, the U.S. Supreme Court reversed and upheld CSAPR, remanding certain portions of CSAPR to the D.C. Circuit for further consideration. On June 26, 2014, the EPA filed a motion asking the D.C. Circuit to lift its stay on CSAPR, and on October 23, 2014, the D.C Circuit lifted its stay of CSAPR. On July 28, 2015, the D.C. Circuit ruled that the EPA's emissions budgets for 13 states including Texas are invalid, but left the rule in place on remand. On October 26, 2016, the EPA published its final CSAPR Update Rule with an effective date of December 27, 2016. While we are unable to determine the full impact of this rule at this time, the Company believes it is currently positioned to comply with CSAPR.

National Ambient Air Quality Standards ("NAAQS"). Under the Clean Air Act ("CAA"), the EPA sets NAAQS for six criteria pollutants considered harmful to public health and the environment, including particulate matter ("PM"), NOx, carbon monoxide ("CO"), ozone, and SO2. NAAQS must be reviewed by the EPA at five-year intervals. In 2010, the EPA tightened the NAAQS for both nitrogen dioxide ("NO2") and SO2. The EPA is considering a 1-hour secondary NAAQS for NO2 and SO2. In January 2013, the EPA tightened the NAAQS for fine PM. On October 1, 2015, following on its November 2014 proposal, the EPA released a final rule tightening the primary and secondary NAAQS for ground-level ozone from its 2008 standard levels of 75 parts per billion ("ppb") to 70 ppb. Ozone is the main component of smog. While not directly emitted into the air, it forms from precursors, including NOx and volatile organic compounds, in combination with sunlight. The EPA is expected to make attainment/nonattainment

designations for the revised ozone standards by October 1, 2017. While it is currently unknown how the areas in which we operate will ultimately be designated, for nonattainment areas classified as "Moderate" and above, states, and any tribes that choose to do so, are expected to be required to complete development of implementation plans in the 2020-2021 timeframe. Most nonattainment areas are expected to have until 2020 or 2023 to meet the primary (health) standard, with the exact attainment date varying based on the ozone level in the area. The Company continues to evaluate what impact these final and proposed NAAQS could have on its operations. If the Company is required to install additional equipment to control emissions at its facilities, the NAAQS, individually or in the aggregate, could have a material impact on its operations and financial results.

Other Laws and Regulations and Risks. The Company sold its interest in Four Corners to APS on July 6, 2016. The Company no longer owns any coal-fired generation, and therefore has reduced its exposure to a number of environmental matters. As of the closing date of the sale, the Company's environmental liabilities associated with Four Corners were limited to conditions that existed at the time of the sale. The Company's liability is limited to the portion thereof for which the Company would have been financially responsible if Four Corners had fully ceased operations on July 6, 2016. The Company believes it is not responsible for a significant portion of the compliance or ongoing operational costs associated with the Mercury and Air Toxics Standards ("MATS"), the Coal Combustion Residue ("CCR") Rule, or the revised Wastewater Effluent Limitation Guidelines ("ELG"). While the outcome of these matters cannot be predicted with certainty, the Company does not expect the MATS, CCR, or ELG rules to have a significant impact on its financial condition or results of operations, nor does the Company expect that ongoing lawsuits between environmental organizations, the Office of Surface Mining Reclamation and Enforcement, the Bureau of Indian Affairs, and other federal agencies will have a significant impact on its financial condition or results of operations.
Mercury and Air Toxics Standards. The operation of coal-fired power plants, such as Four Corners, results in emissions of mercury and other air toxics. In December 2011, the EPA finalized the MATS Rule for oil- and coal-fired power plants, which requires significant reductions in emissions of mercury and other air toxics. Several judicial and other challenges have been made to this rule, and on June 29, 2015, the U.S. Supreme Court remanded the rule to the D.C. Circuit Court. On December 15, 2015, the D.C. Circuit Court issued an order remanding the rule to the EPA but did not vacate the rule during remand. On April 15, 2016, the EPA completed a cost-benefit analysis of the MATS rule and reaffirmed its finding that the rule is "appropriate and necessary," which will be reviewed by the D.C. Circuit Court. The legal status of the MATS Rule notwithstanding, the Company believes, under the terms of the Purchase and Sale Agreement and after the sale, as a former owner, that the Company is not responsible for a significant portion of the costs under the MATS Rule. Accordingly, the Company does not expect the MATS Rule to have a significant impact on its financial condition or results of operations.
Coal Combustion Waste. On October 19, 2015, the EPA's final rule regulating the disposal of CCR (the "CCR Rule") from electric utilities as solid waste took effect. As of the effective date of the CCR Rule, the Company had a 7% ownership interest in Units 4 and 5 of Four Corners, the only coal-fired generating facility for which the Company had an ownership interest subject to the CCR Rule. The Company sold its entire ownership interest in Four Corners to APS on July 6, 2016. The CCR Rule requires plant owners to treat coal combustion residuals as Subtitle D (as opposed to a more costly Subtitle C) waste. The Company, however, believes, under the terms of the Purchase Agreement and after the sale, as a former owner, that the Company is not responsible for a significant portion of the costs under the CCR Rule, such as ongoing operational costs after July 6, 2016 . Accordingly, the Company does not expect the CCR Rule to have a significant impact on its financial condition or results of operations.
On November 3, 2015, the EPA published a final rule revising wastewater effluent limitation guidelines for steam electric power generators (the "Revised ELG Rule"). The Revised ELG Rule establishes requirements for wastewater streams from certain processes at affected facilities, including limits on toxic metals in wastewater discharges. Facilities must comply with the Revised ELG Rule between 2018 and 2023. The EPA anticipates that the new requirements in the Revised ELG Rule will only affect certain coal-fired steam electric power plants. Because the Company does not have an interest in Four Corners after the closing of the sale in July 2016, the Company does not expect the Revised ELG Rule will have a significant impact on its financial condition or results of operations.
In 2012, several environmental groups filed a lawsuit in federal district court against the Office of Surface Mining Reclamation and Enforcement ("OSM") of the U.S. Department of the Interior, challenging OSM’s 2012 approval of a permit revision which allowed for the expansion of mining operations into a new area of the mine that serves Four Corners ("Area IV North"). In April 2015, the court issued an order invalidating the permit revision, thereby prohibiting mining in Area IV North until OSM takes action to cure the defect in its permitting process identified by the court. On December 29, 2015, OSM took action to cure the defect in its permitting process by issuing a revised

environmental assessment and finding of no new significant impact, and reissued the permit. This action is subject to possible judicial review. On March 30, 2016, the U.S. Court of Appeals vacated and dismissed the federal court decision that halted operations in Area IV North at the Navajo Mine.

On April 20, 2016, the same environmental groups filed a new complaint in Arizona's federal district court, challenging multiple permits and approvals issued to both the Navajo Mine and Four Corners authorizing operations from July 2016 onwards. The complaint seeks to enjoin federal agencies, including the OSM and Bureau of Indian Affairs, from authorizing any element of the power plant or mine without further environmental impact analysis.

Climate Change. In recent years, there has been increasing public debate regarding the potential impact of global climate change. There has been a wide-ranging policy debate, both nationally and internationally, regarding the impact of GHG and possible

means for their regulation. In addition, efforts have been made and continue to be made in the international community toward the adoption of international treaties or protocols that would address global climate change issues. Most recently, in 2015, the United States participated in the United Nations Conference on Climate Change, which led to creation of the Paris Agreement. On April 22, 2016, 175 countries, including the United States, signed the Paris Agreement, signaling their intent to join. Those countries that subsequently ratify the agreement will be required to review and "represent a progression" in their intended nationally determined contributions, which set GHG emission reduction goals, every five years, beginning in 2020.

The U.S. federal government has either considered, proposed, and/or finalized legislation or regulations limiting GHG emissions, including carbon dioxide. In particular, the U.S. Congress has considered legislation to restrict or regulate GHG emissions. In the past few years, the EPA began using the CAA to regulate carbon dioxide and other GHG emissions, such as the 2009 GHG Reporting Rule and the EPA's sulfur hexafluoride ("SF6") reporting rule, both of which apply to the Company, as well as the EPA's 2010 actions to impose permitting requirements on new and modified sources of GHG emissions. After announcing his plan to address climate change in 2013, the President directed the EPA to issue proposals for GHG rulemaking addressing power plants. In October 2015, the EPA published a final rule establishing new source performance standards ("NSPS") limiting CO2 emissions from new, modified, and reconstructed electric generating units. In October 2015, the EPA also published a rule establishing guidelines for states to regulate CO2 emissions from existing power plants, as well as a proposed "federal plan" to address CO2 emissions from affected units in those states that do not submit an approvable compliance plan. The standards for existing plants are known as the Clean Power Plan ("CPP"), under which rule interim emissions performance rates must be achieved beginning in 2022 and final emissions performance rates by 2030. Legal challenges to the CPP were filed by groups of states and industry members. On February 9, 2016, the U.S. Supreme Court issued a decision to stay the rule until legal issues are resolved. We cannot at this time determine the impact the CPP and related rules and legal challenges may have on our financial position, results of operations, or cash flows.

H. Litigation

The Company is involved in various legal, environmental, tax and regulatory proceedings before various courts, regulatory commissions and governmental agencies regarding matters arising in the ordinary course of business. In many of these matters, the Company has excess casualty liability insurance that covers the various claims, actions and complaints. The Company regularly analyzes current information and, as necessary, makes provisions in its financial statements for probable liabilities for the eventual disposition of these matters. While the outcome of these matters cannot be predicted with certainty, based upon a review of the matters and applicable insurance coverage, the Company believes that none of these matters will have a material adverse effect on the financial position, results of operations or cash flows of the Company. The Company expenses legal costs, including expenses related to loss contingencies, as they are incurred.

See Notes C and G above and Notes C and K of the Notes to Financial Statements in the 2015 Form 10-K for discussion of the effects of government legislation and regulation on the Company.

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I. Employee Benefits
Retirement Plans
The net periodic benefit cost recognized for the three, nine and twelve months ended September 30, 2016 and 2015 is made up of the components listed below as determined using the projected unit credit actuarial cost method (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,		Twelve Months Ended September 30,	
	2016	2015	2016	2015	2016	2015
Components of net periodic benefit cost:						
Service cost	$2,191	$2,394	$6,001	$6,594	$8,199	$8,707
Interest cost	3,250	3,622	9,780	10,872	13,403	14,563
Expected return on plan assets	(4,734)	(4,951)	(14,159)	(14,846)	(19,108)	(19,528)
Amortization of:						
Net loss	1,730	2,485	5,505	7,985	8,167	10,267
Prior service benefit	(875)	(855)	(2,630)	(2,630)	(3,506)	(3,506)
Net periodic benefit cost	$1,562	$2,695	$4,497	$7,975	$7,155	$10,503

During the nine months ended September 30, 2016, the Company contributed $8.8 million of its projected $9.4 million 2016 annual contribution to its retirement plans.
Other Postretirement Benefits
The net periodic benefit cost recognized for the three, nine and twelve months ended September 30, 2016 and 2015 is made up of the components listed below (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,		Twelve Months Ended September 30,	
	2016	2015	2016	2015	2016	2015
Components of net periodic benefit cost:						
Service cost	$749	$841	$2,179	$2,591	$3,042	$3,302
Interest cost	871	976	2,616	3,026	3,625	4,142
Expected return on plan assets	(452)	(503)	(1,372)	(1,553)	(1,889)	(2,082)
Amortization of:						

10.10

10.25#	Settlement Agreement and General Release of Claims, dated as of October 16, 2009, among Kratos Defense & Security Solutions, Inc., KeyBank National Association, Field Point III, Ltd. and SPF	10-Q	09/27/2009	(001-34460)	10.10

	CDO I, Ltd.			
10.26#	Sublease Agreement, dated as of December 17, 2009, by and between Amylin Pharmaceuticals, Inc. (Sublessor) and Kratos Defense & Security Solutions, Inc. (Sublessee).	10-K	12/27/2009(000-34460)	10.26
10.27	Purchase Agreement, dated as of May 12, 2010, by and among Kratos Defense & Security Solutions, Inc., the Guarantors set forth therein, Jefferies & Company, Inc., B. Riley & Co., LLC, Imperial Capital, LLC, Keybanc Capital Markets Inc. and Noble International Investments, Inc.	8-K	05/25/2010	10.10
10.28	Security Agreement, dated as of May 19, 2010, by and among Kratos Defense & Security Solutions, Inc., the Guarantors set forth therein and Wilmington Trust FSB, as Collateral Agent.	8-K	05/25/2010	10.20
10.29	Intercreditor Agreement, dated as of May 19, 2010, by and among Kratos Defense & Security Solutions, Inc., the Guarantors set forth therein, Wilmington Trust FSB, as Indenture Agent, and KeyBank National Association, as Credit Facility Agent.	8-K	05/25/2010	10.30
10.30	Credit Agreement, dated as of March 3, 2010, among Kratos Defense & Security Solutions, Inc., KeyBank National Association, as Administrative Agent and Lender, Bank of America, N.A., as Syndication Agent and Lender, and the other financial institutions parties thereto with Keybanc Capital Markets and Banc of America Securities,	8-K	03/08/2010(001-34460)	10.10

	LLC, as Co-Lead Arrangers and Book Runners.			
10.31	First Amendment Agreement, dated as of December 13, 2010, by and among Kratos Defense & Security Solutions, Inc., as Borrower, the Lenders named therein and KeyBank National Association, as Lead Arranger, Sole Book Runner and Administrative Agent.	8-K	12/16/2010	10.10
10.32	Second Amendment Agreement, dated as of February 7, 2011, among Kratos Defense & Security solutions, the Lenders named therein and KeyBank National Association.	8-K	02/07/2011	10.30
10.33	Purchase Agreement, dated March 22, 2011, by and among Kratos Defense & Security Solutions, Inc., Acquisition Co. Lanza Parent, Lanza Acquisition Co., the guarantors named therein, Jefferies & Company, Inc., KeyBanc Capital Markets, Inc. and Oppenheimer & Co. Inc.	8-K	03/29/2011	10.10

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Exhibit Number	Exhibit Description	Incorporated by Reference Form	Filing Date/ Period End Date	Exhibit	Filed-Furnished Herewith
10.34	Security Agreement, dated March 25, 2011, by and among Acquisition Co. Lanza Parent, Lanza Acquisition Co. and Wilmington Trust FSB, as Collateral Agent.	8-K	03/29/2011	10.20	
10.35	Credit and Security Agreement, dated as of May 19, 2010, as amended and restated as of July 27, 2011, among Kratos Defense & Security Solutions, Inc., as Borrower, the Lenders named therein and KeyBank National Association, as Lead Arranger, Sole Book Runner and Administrative Agent.	8-K	07/29/2011	10.10	
10.36	First Amendment Agreement, dated as of November 14, 2011, by and among Kratos Defense & Security Solutions, Inc., as Borrower, the Lenders named therein, and Key Bank National Association, as Lead Arranger, Sole Book Runner and Administrative Agent.	8-K	11/18/2011	10.10	
10.37	Purchase Agreement, dated July 14, 2011, by and among Kratos Defense & Security Solutions, Inc., the Guarantors named therein, Jefferies & Company, Inc., KeyBanc Capital Markets Inc. and B. Riley & Co., LLC, as amended by that certain Joinder Agreement, dated July 27, 2011.	10-Q	09/25/2011	10.20	
10.38	Stipulation and Agreement of Settlement of Derivative Claims, dated as of January 5, 2010.	10-K	12/27/2009(001-34460)	10.60	
10.39	Amended and Restated Herley Industries, Inc. 2010 Stock Plan, and the forms of agreement related thereto.	S-8	03/08/2012	4.10	
10.40	Amended and Restated Integral Systems, Inc. 2008 Stock Incentive Plan, and the forms of agreement related thereto.	S-8	03/08/2012	4.11	
10.41		8-K	05/08/2012	10.10	

	Second Amendment to Credit and Security Agreement, dated as of May 4, 2012, among Kratos Defense & Security Solutions, the lenders named therein, and KeyBank National Association.			
10.42	Third Amendment to Credit and Security Agreement, dated as of May 8, 2012, among Kratos Defense & Security Solutions, the lenders named therein, and KeyBank National Association.	8-K	05/08/2012	10.20
10.43	Standstill Agreement, dated May 14, 2012, between Kratos Defense & Security Solutions, Inc., Bandel Carano, Oak Investment Partners IX, L.P., Oak IX Affiliates Fund, L.P., Oak IX Affiliates Fund-A, L.P., Oak X Affiliates Fund, L.P., Oak Investment Partners X, L.P., and Oak Investment Partners XIII, L.P.	8-K	05/15/2012	10.10
10.44	Form of Restricted Stock Unit Agreement entered into between Kratos Defense & Security Solutions, Inc. and certain employees of Composite Engineering, Inc.	S-8	07/27/2012	4.10

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Exhibit Number	Exhibit Description	Incorporated by Reference Form	Filing Date/ Period End Date	Exhibit	Filed- Furnished Herewith
10.45	Fourth Amendment to Credit and Security Agreement, dated as of February 27, 2013, among Kratos Defense & Security Solutions, the lenders named therein, and KeyBank National Association.	10-Q	05/09/2013	10.1	
10.46#	Employment Agreement, effective January 17, 2014, by and between Kratos Defense & Security Solutions, Inc. and Phil Carrai.	8-K	01/22/2014	10.1	
21.1	List of Subsidiaries.				*
23.1	Consent of Independent Registered Public Accounting Firm.				*
23.2	Consent of Independent Registered Public Accounting Firm.				*
31.1	Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes Oxley Act of 2002.				*
31.2	Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes Oxley Act of 2002.				*
32.1	Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 for Eric M. DeMarco.				*
32.2	Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 for Deanna Lund.				*
101	Financial statements from the Annual Report on Form 10K of Kratos Defense & Security Solutions, Inc. for the year ended December 29, 2013, formatted in XBRL: (i) the Consolidated Balance Sheets, (ii) the Consolidated Statements of Operations and Comprehensive Loss, (iii) the Consolidated Statements of Cash Flows, (iv) the Notes to the Consolidated Financial Statements.				*

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

Securities and Exchange Commission upon request.

Management contract or compensatory plan or arrangement.

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(b) Exhibits
See Item 15(a)(3) above.

(c) Financial Statement Schedules
See Item 15(a)(2) above.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.
Date: March 11, 2014

Kratos Defense & Security Solutions, Inc.

By: /s/ Eric M. DeMarco
Eric M. DeMarco
President and Chief Executive Officer (Principal Executive Officer)

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the date indicated:

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Signature	Title	Date
/s/ Eric M. DeMarco Eric M. DeMarco	President, Chief Executive Officer and Director (Principal Executive Officer)	March 11, 2014
/s/ Deanna H. Lund Deanna H. Lund	Executive Vice President, Chief Financial Officer (Principal Financial Officer)	March 11, 2014
/s/ Deborah S. Butera Deborah S. Butera	Senior Vice President, General Counsel, Chief Compliance Officer and Secretary / Registered In-House Counsel	March 11, 2014
/s/ Richard Duckworth Richard Duckworth	Vice President and Corporate Controller (Principal Accounting Officer)	March 11, 2014
/s/ Scott Anderson Scott Anderson	Director	March 11, 2014
/s/ Bandel Carano Bandel Carano	Director	March 11, 2014
/s/ William Hoglund William Hoglund	Director	March 11, 2014
/s/ Scot Jarvis Scot Jarvis	Director	March 11, 2014
/s/ Jane E. Judd Jane E. Judd	Director	March 11, 2014
/s/ Sam Liberatore Sam Liberatore	Director	March 11, 2014

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of
Kratos Defense & Security Solutions, Inc.
San Diego, California

We have audited the accompanying consolidated balance sheet of Kratos Defense & Security Solutions, Inc. and subsidiaries (the "Company") as of December 29, 2013, and the related consolidated statements of operations and comprehensive loss, stockholders' equity, and cash flows for the year ended December 29, 2013. We also have audited the Company's internal control over financial reporting as of December 29, 2013, based on criteria established in Internal Control - Integrated Framework (1992) issued by the Committee of Sponsoring Organizations of the Treadway Commission. The Company's management is responsible for these financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management's Report on Internal Control Over Financial Reporting. Our responsibility is to express an opinion on these financial statements and an opinion on the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audit of the financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed by, or under the supervision of, the company's principal executive and principal financial officers, or persons performing similar functions, and effected by the company's board of directors, management, and other personnel to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of the inherent limitations of internal control over financial reporting, including the possibility of collusion or improper management override of controls, material misstatements due to error or fraud may not be prevented or detected on a timely basis. Also, projections of any evaluation of the effectiveness of the internal control over financial reporting to future periods are subject to the risk that the controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of the Company as of December 29, 2013, and the results of their operations and their cash flows for the year ended December 29, 2013, in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 29, 2013, based on the criteria established in Internal Control - Integrated Framework (1992) issued by the Committee of Sponsoring Organizations of the Treadway Commission.

/s/ DELOITTE & TOUCHE LLP

San Diego, California
March 11, 2014

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors and Stockholders
Kratos Defense & Security Solutions, Inc.

We have audited the accompanying consolidated balance sheet of Kratos Defense & Security Solutions, Inc. (the "Company") as of December 30, 2012, and the related consolidated statements of operations and comprehensive income (loss), stockholders' equity, and cash flows for each of the two years in the period ended December 30, 2012. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Kratos Defense & Security Solutions, Inc. as of December 30, 2012, and the results of its operations and its cash flows for each of the two years in the period ended December 30, 2012 in conformity with accounting principles generally accepted in the United States of America.

/s/ GRANT THORNTON LLP
San Diego, California
March 12, 2013

KRATOS DEFENSE & SECURITY SOLUTIONS, INC.
CONSOLIDATED BALANCE SHEETS
December 30, 2012 and December 29, 2013
(in millions, except par value and number of shares)

	2012	2013
Assets		
Current assets:		
Cash and cash equivalents	$49.0	$55.7
Restricted cash	5.5	5.0
Accounts receivable, net	271.9	265.8
Inventoried costs	94.3	74.6
Income taxes receivable	3.7	2.1
Prepaid expenses	17.4	10.4
Other current assets	7.0	16.7
Other current assets of discontinued operations	6.6	—
Total current assets	455.4	430.3
Property, plant and equipment, net	85.6	84.8
Goodwill	596.4	596.4
Intangible assets, net	106.1	69.9
Other assets	39.6	35.2
Other assets of discontinued operations	0.8	—
Total assets	$1,283.9	$1,216.6
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	$83.6	$61.9
Accrued expenses	46.4	46.2
Accrued compensation	47.8	44.9
Accrued interest	6.3	5.2
Billings in excess of costs and earnings on uncompleted contracts	43.7	52.5
Deferred income tax liability	28.9	28.4
Other current liabilities	15.7	8.1
Current portion of long-term debt	1.0	1.0
Current portion of capital lease obligations	0.5	0.3
Current liabilities of discontinued operations	4.9	2.5
Total current liabilities	278.8	251.0
Long-term debt principal, net of current portion	629.7	628.8
Long-term debt premium	18.7	14.5
Capital lease obligations, net of current portion	0.4	0.1
Deferred income tax liability	—	0.7
Other long-term liabilities	31.9	25.5
Long-term liabilities of discontinued operations	0.3	0.2
Total liabilities	959.8	920.8
Commitments and contingencies		
Stockholders' equity:		
Preferred stock, $0.001 par value, 5,000,000 authorized, 0 shares outstanding at December 30, 2012 and December 29, 2013	—	—
Common stock, $0.001 par value, 195,000,000 shares authorized; 56,613,024 and 57,056,892 shares issued and outstanding at December 30, 2012 and December 29, 2013, respectively	—	—

Additional paid-in capital	847.1	856.0
Accumulated other comprehensive loss	(0.8)	(0.8)
Accumulated deficit	(522.2)	(559.4)
Total stockholders' equity	324.1	295.8
Total liabilities and stockholders’ equity	$1,283.9	$1,216.6

The accompanying notes are an integral part of these Consolidated Financial Statements.

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KRATOS DEFENSE & SECURITY SOLUTIONS, INC.
CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE LOSS
Years ended December 25, 2011, December 30, 2012, and December 29, 2013
(in millions, except per share amounts)

	2011		2012		2013	
Service revenues	$351.0		$450.0		$443.6	
Product sales	362.9		519.2		507.0	
Total revenues	713.9		969.2		950.6	
Cost of service revenues	260.7		350.8		335.2	
Cost of product sales	262.0		361.2		375.4	
Total costs	522.7		712.0		710.6	
Gross profit	191.2		257.2		240.0	
Selling, general and administrative expenses	140.6		193.1		193.0	
Merger and acquisition related items	12.5		(2.7	)	(3.8	)
Research and development expenses	8.6		17.8		21.4	
Impairment of goodwill and intangible assets	—		96.6		—	
Unused office space and other	—		2.1		(2.4	)
Operating income (loss) from continuing operations	29.5		(49.7	)	31.8	
Other income (expense):						
Interest expense, net	(51.1	)	(66.1	)	(63.7	)
Other income, net	—		1.3		—	
Total other expense, net	(51.1	)	(64.8	)	(63.7	)
Loss from continuing operations before income taxes	(21.6	)	(114.5	)	(31.9	)
Provision (benefit) for income taxes from continuing operations	1.9		(1.6	)	—	
Loss from continuing operations	(23.5	)	(112.9	)	(31.9	)
Loss from discontinued operations	(0.7	)	(1.5	)	(5.3	)
Net loss	$(24.2	)	$(114.4	)	$(37.2	)
Basic and diluted loss per common share:						
Net loss from continuing operations	$(0.86	)	$(2.41	)	$(0.56	)
Net loss from discontinued operations	(0.02	)	(0.03	)	(0.09	)
Net loss per common share	$(0.88	)	$(2.44	)	$(0.65	)
Weighted average common shares outstanding:						
Basic and diluted	27.4		46.9		56.8	
Comprehensive Loss						
Net loss from above	$(24.2	)	$(114.4	)	$(37.2	)
Other comprehensive loss:						
Change in cumulative translation adjustment	0.1		(0.4	)	—	
Post retirement benefit reserve adjustment net of tax expense	(0.3	)	(0.2	)	—	
Other comprehensive loss, net of tax	(0.2	)	(0.6	)	—	
Comprehensive loss	$(24.4	)	$(115.0	)	$(37.2	)

The accompanying notes are an integral part of these Consolidated Financial Statements.

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KRATOS DEFENSE & SECURITY SOLUTIONS, INC.
CONSOLIDATED STATEMENTS OF STOCKHOLDER'S EQUITY
Years ended December 25, 2011, December 30, 2012, and December 29, 2013
(in millions)

	Common Stock		Additional Paid-In Capital	Accumulated Other Comprehensive Loss	Accumulated Deficit	Total Stockholders' Equity
	Shares	Amounts				
Balance, December 26, 2010	18.6	$ —	$ 553.5	$ —	$ (383.6)	$ 169.9
Issuance of common stock for employee stock purchase plan, options and warrants	0.4	—	2.0	—	—	2.0
Issuance of common stock for cash	4.9	—	61.1	—	—	61.1
Issuance of common stock for acquisitions	10.4	—	109.7	—	—	109.7
Fair value of options assumed for acquisitions	—	—	1.9	—	—	1.9
Stock-based compensation	—	—	3.3	—	—	3.3
Conversion of convertible notes	0.1	—	—	—	—	—
Common stock repurchased	(2.0)	—	(10.9)	—	—	(10.9)
Net loss	—	—	—	—	(24.2)	(24.2)
Other comprehensive loss, net of tax	—	—	—	(0.2)	—	(0.2)
Balance, December 25, 2011	32.4	—	720.6	(0.2)	(407.8)	312.6
Issuance of common stock for cash	20.0	—	97.0	—	—	97.0
Issuance of common stock for acquisitions	4.0	—	23.8	—	—	23.8
Stock-based compensation	—	—	6.6	—	—	6.6
Issuance of common stock for employee stock purchase plan, options and warrants	0.2	—	—	—	—	—
Common stock repurchased for employee stock purchase plan	—	—	(0.7)	—	—	(0.7)
Restricted stock units traded for taxes	—	—	(0.2)	—	—	(0.2)
Net loss	—	—	—	—	(114.4)	(114.4)
Other comprehensive loss, net of tax	—	—	—	(0.6)	—	(0.6)
Balance, December 25, 2012	56.6	—	847.1	(0.8)	(522.2)	324.1
Stock-based compensation	—	—	7.4	—	—	7.4
Issuance of common stock for employee stock purchase plan, options and warrants	0.3	—	1.6	—	—	1.6
Restricted stock units traded for taxes	0.1	—	(0.1)	—	—	(0.1)
Net loss	—	—	—	—	(37.2)	(37.2)
Other comprehensive loss, net of tax	—	—	—	—	—	—
Balance, December 29, 2013	57.0	$ —	$ 856.0	$ (0.8)	$ (559.4)	$ 295.8

The accompanying notes are an integral part of these Consolidated Financial Statements.

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KRATOS DEFENSE & SECURITY SOLUTIONS, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
Years ended December 25, 2011, December 30, 2012, and December 29, 2013
(in millions)

	2011	2012	2013
Operating activities:			
Net loss	$(24.2)	$(114.4)	$(37.2)
Loss from discontinued operations	(0.7)	(1.5)	(5.3)
Loss from continuing operations	(23.5)	(112.9)	(31.9)
Adjustments to reconcile net loss from continuing operations to net cash provided by operating activities from continuing operations:			
Depreciation and amortization	48.0	58.0	53.4
Deferred income taxes	(0.1)	(2.5)	(0.4)
Stock-based compensation	3.3	6.6	7.4
Mark to market on swaps	(0.3)	—	—
Goodwill and intangible assets impairment charge	—	96.6	—
Amortization of deferred financing costs	3.8	5.1	5.1
Amortization of premium on Senior Secured Notes	(2.8)	(4.2)	(4.2)
Provision for doubtful accounts	1.8	0.4	1.0
Change in accrual for excess facilities	—	1.8	(4.7)
Changes in assets and liabilities, net of acquisitions:			
Accounts receivable	(14.4)	2.8	4.9
Inventoried costs	4.3	(5.2)	20.0
Prepaid expenses	1.4	(1.7)	1.9
Other assets	1.3	(0.2)	(7.0)
Accounts payable	(15.8)	25.6	(22.0)
Accrued expenses	1.0	(10.3)	(0.7)
Accrued compensation	(3.8)	4.3	(3.0)
Accrued interest	3.1	1.2	(1.1)
Billings in excess of costs and earnings on uncompleted contracts	(1.8)	(5.0)	8.8
Income tax receivable and payable	(0.2)	(0.7)	1.6
Other liabilities	(0.1)	(7.4)	(6.5)
Net cash provided by operating activities from continuing operations	5.2	52.3	22.6
Investing activities:			
Cash paid for acquisitions, net of cash acquired	(391.1)	(149.4)	2.2
Proceeds from the disposition of discontinued operations	—	0.3	1.3
Cash transferred from restricted cash	3.0	0.6	0.4
Capital expenditures	(7.5)	(16.6)	(16.6)
Net cash used in investing activities from continuing operations	(395.6)	(165.1)	(12.7)
Financing activities:			
Proceeds from the issuance of long-term debt, net of issuance costs	425.7	—	—
	61.1	97.0	—

Proceeds from the issuance of common stock, net of issuance costs			
Borrowing under credit facility	—	50.0	—
Repayments under credit facility	(2.7)	(51.0)	(1.0)
Purchase of treasury stock	(10.9)	—	—
Cash paid for contingent acquisition consideration	—	(2.5)	(2.1)
Debt issuance costs	(22.1)	(1.2)	—
Proceeds from exercise of restricted stock units, employee stock options, and employee stock purchase plan	2.0	—	1.5
Other	(0.7)	(1.4)	(0.4)
Net cash provided by (used in) financing activities from continuing operations	452.4	90.9	(2.0)
Net cash flows of continuing operations	62.0	(21.9)	7.9
Net operating cash flows of discontinued operations	(2.7)	1.3	(1.3)
Effect of exchange rate changes on cash and cash equivalents	(0.5)	—	0.1
Net increase (decrease) in cash and cash equivalents	58.8	(20.6)	6.7
Cash and cash equivalents at beginning of year	10.8	69.6	49.0
Cash and cash equivalents at end of year	$69.6	$49.0	$55.7
Supplemental disclosure of cash flow information:			
Cash paid during the year for interest	$46.2	$64.0	$63.8
Net cash paid during the year for income taxes	$1.5	$2.7	$0.2
Non-cash investing and financing activities:			
Common stock and stock options issued for acquisitions	$111.6	$23.8	$—
Liability for contingent cash consideration	$1.8	$2.1	$—
Supplemental disclosures of non-cash investing and financing transactions:			
Fair value of assets acquired in acquisitions	$731.3	$218.3	$—
Liabilities assumed in acquisitions	$197.2	$35.2	$—

The accompanying notes are an integral part of these Consolidated Financial Statements.

KRATOS DEFENSE & SECURITY SOLUTIONS, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 1. Organization and Summary of Significant Accounting Policies

(a) Description of Business

Kratos Defense & Security Solutions, Inc. (“Kratos” or the “Company”) is a specialized security technology business providing mission critical products, solutions and services for domestic and international customers, with its principal customers being agencies of the U.S. Government. Kratos' core capabilities are sophisticated engineering, manufacturing, technology development, and system integration, and test and evaluation offerings for national security platforms and programs. Its principal products and solutions are related to Command, Control, Communications, Computing, Combat Systems, Intelligence, Surveillance and Reconnaissance (“C5ISR”); design, engineer and manufacture specialized electronic components, subsystems and systems for electronic attack, electronic warfare, radar, and missile system platforms; integrated technology solutions for satellite communications; products and solutions for unmanned systems; products and services related to cybersecurity and cyberwarfare; products and solutions for ballistic missile defense; weapons systems trainers; advanced network engineering and information technology services; weapons systems lifecycle support and sustainment; military weapon range operations and technical services; and public safety, critical infrastructure security and surveillance systems.

The Company conducts most of its business with the U.S. Government (which includes foreign military sales) and performs work as the prime contractor, subcontractor, or preferred supplier. The Company also conducts business with local, state, and foreign governments and domestic and international commercial customers.

The Company operates in two principal business segments: Kratos Government Solutions (“KGS”) and Public Safety & Security (“PSS”). The Company organizes its 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 on Form 10-K (this “Annual Report”) are presented in a manner consistent with the Company's operating structure. For additional information regarding the Company's operating segments, see Note 14 of the Notes to the Consolidated Financial Statements.

b) Principles of Consolidation and Basis of Presentation

The Consolidated Financial Statements include the accounts of Kratos and its wholly-owned subsidiaries, for which all intercompany transactions have been eliminated in consolidation.

In June 2012, the Company committed to a plan to sell certain lines of business associated with antennas, satellite-cased products and fly-away terminals of the non-core businesses acquired in the Integral acquisition. In accordance with Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") Topic 205, Presentation of Financial Statements (“Topic 205”), these businesses have been classified as held for sale and reported in discontinued operations in the accompanying Consolidated Financial Statements. See Note 9.

(c) Fiscal Year

The Company has a 52/53 week fiscal year ending on the last Sunday of the calendar year, with interim fiscal periods ending on the last Sunday of each calendar quarter. There were 52 calendar weeks in the fiscal years ended on

December 25, 2011 and December 29, 2013. There were 53 calendar weeks in the fiscal year ended on December 30, 2012.

(d) Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States ("U.S. GAAP") requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Such estimates include

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

(e) Revenue Recognition

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

The Company has three basic categories of fixed-price contracts: fixed unit price, fixed-price-level of effort, and fixed-price-completion. Revenue recognition methods on fixed-price contracts will vary depending on the nature of the work and the contract terms. Revenues on fixed-price service contracts are recorded as work is performed in accordance with ASC Topic 605, Revenue Recognition (“Topic 605”), specifically Topic 605-10-S99, which generally requires revenue to be deferred until all of the following have occurred: (1) there is a contract in place; (2) delivery has occurred or services have been provided; (3) the price is fixed or determinable; and, (4) collectability is reasonably assured. Revenues on fixed-price contracts that require delivery of specific items may be recorded based on a price per unit as units are delivered. Revenue for fixed-price contracts in which the Company is paid a specific amount to provide services for a stated period of time is recognized ratably over the service period.

On a portion of the fixed price-completion contracts, revenue is recognized in accordance with Topic 605 using the percentage-of-completion method based on the ratio of total costs incurred to date compared to estimated total costs to complete the contract. Estimates of costs to complete include material, direct labor, overhead, and allowable indirect expenses for government contracts. These cost estimates are reviewed and, if necessary, revised on a contract-by-contract basis. If, as a result of this review, management determines that a loss on a contract is evident, then the full amount of estimated loss is charged to operations in the period. As of December 30, 2012 and December 29, 2013, the provisions for losses on contracts were $4.2 million and $4.8 million, respectively.

In certain instances, when the Company's customers have requested that it commence work prior to receipt of the contract award and funding and it has incurred costs related to that specific anticipated contract, and the Company believes recoverability of the costs is probable, it may defer those costs incurred until the associated contract has been awarded and funded by the customer.

In accounting for the Company's long-term contracts for production of products provided to the U.S. Government, the Company utilizes both cost-to-cost and units delivered measures under the percentage-of-completion method of accounting under the provisions of Topic 605. Under the units delivered measure of the percentage-of-completion method of accounting, sales are recognized as the units are accepted by the customer generally using sales values for units in accordance with the contract terms. The Company estimates profit as the difference between total estimated

revenue and total estimated cost of a contract and recognizes that profit over the life of the contract based on units delivered or as computed on the basis of the estimated final average unit costs plus profit. The Company classifies contract revenues as product sales or service revenues depending upon the predominant attributes of the relevant underlying contracts.

Significant management judgments and estimates, including but not limited to the estimated costs to complete projects, must be made and used in connection with the revenue recognized in any accounting period. A cancellation, schedule delay, or modification of a fixed-price contract which is accounted for using the percentage-of-completion method may adversely affect the Company's gross margins for the period in which the contract is modified or canceled. Under certain circumstances, a cancellation or negative modification could result in the Company having to

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reverse revenue that was recognized in a prior period, thus significantly reducing the amount of revenues recognized for the period in which the adjustment is made. Correspondingly, a positive modification may positively affect gross margins. In addition, a schedule delay or modifications can result in an increase in estimated cost to complete the project, which would also result in an impact to gross margins. Material differences may result in the amount and timing of the Company's revenue for any period if management made different judgments or utilized different estimates.

It is the Company's policy to review any arrangement containing software or software deliverables and services against the criteria contained in ASC Topic 985, Software (“Topic 985”). Under the provisions of Topic 985, the Company reviews the contract value of software deliverables and services and determines allocations of the contract value based on vendor-specific objective evidence (“VSOE”) of fair value for each of the software elements. All software arrangements requiring significant production, modification, or customization of the software are accounted for in conformity with Topic 605.

The Company's contracts may include the provision of more than one of its services (“multiple element arrangements”). In these situations, the Company applies the guidance of Topic 605. Accordingly, for applicable arrangements, revenue recognition includes the proper identification of separate units of accounting and the allocation of revenue across all elements based on relative fair values.

For multiple element arrangements that include hardware products containing software essential to the hardware products' functionality, the Company allocates revenue to all deliverables based on their relative selling prices. In such circumstances, the Company uses a hierarchy to determine the selling price to be used for allocating revenue to deliverables: (i) VSOE, (ii) third-party evidence of selling price (“TPE”), and (iii) best estimate of the selling price (“ESP”).

VSOE generally exists only when the Company sells the deliverable separately and is the price actually charged by the Company for that deliverable. TPE is determined based on competitor prices for similar deliverables when sold separately. Generally, the Company's offerings contain significant differentiation such that comparable pricing of products with similar functionality cannot be obtained. Furthermore, the Company is unable to reliably determine what similar competitor products' selling prices are on a stand-alone basis. Therefore, the Company typically is unable to obtain TPE of selling price. ESP reflects the Company's best estimates of what the selling prices of elements would be if they were sold regularly on a stand-alone basis. The Company determines ESP for a product or service by considering multiple factors including, but not limited to major product groupings, geographies, market conditions, competitive landscape, internal costs, gross margin objectives and pricing practices. The determination of ESP is made through consultation with management, taking into consideration the Company's marketing strategy.

The Company accounts for multiple element arrangements that consist only of software or software-related products, including the sale of upgrades to previously sold software, in accordance with industry specific software accounting guidance. For such transactions, revenue on arrangements that include multiple elements is allocated to each element based on the relative fair value of each element, and fair value is determined by VSOE. If the Company cannot objectively determine the fair value of any undelivered element included in such multiple element arrangements, the Company defers revenue until all elements are delivered and services have been performed, or until fair value can objectively be determined for any remaining undelivered elements. Under certain of the Company's contractual arrangements, the Company may also recognize revenue for out-of-pocket expenses in accordance with Topic 605. Depending on the contractual arrangement, these expenses may be reimbursed with or without a fee.

Under certain of its contracts, the Company provides supplier procurement services and materials for its customers. The Company records revenue on these arrangements on a gross or net basis in accordance with Topic 605, depending on the specific circumstances of the arrangement. The Company considers the following criteria, among others, for

recording revenue on a gross or net basis:

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

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

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

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(4) Whether the Company serves as an agent or broker, with compensation on a commission or fee basis; and,

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

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

From time to time, the Company may proceed with work based on customer direction prior to the completion and signing of formal contract documents. The Company has a formal review process for approving any such work. Revenue associated with such work is recognized only when it can be reliably estimated and realization is probable. The Company bases its estimates on previous experiences with the customer, communications with the customer regarding funding status, and its knowledge of available funding for the contract or program. As of December 30, 2012 and December 29, 2013, approximately $3.7 million and $3.7 million, respectively, of the Company's unbilled accounts receivable balance were under an authorization to proceed or work order from its customers where a formal purchase order had not yet been received.

Costs incurred for shipping and handling are included in cost of product sales at the time the related revenue is recognized. Amounts billed to a customer for shipping and handling are reported as revenue.

(f) Inventoried costs

Inventoried costs are stated at the lower of cost or market. Cost is determined using the average cost or first-in, first-out methods and the applicable method is applied consistently within an operating entity. Inventoried costs primarily relate to work under fixed-price contracts using the percentage-of-completion under the units of delivery method of revenue recognition. These costs represent accumulated contract costs less the portion of such costs allocated to delivered items. Accumulated contract costs include direct production costs, factory and engineering overhead and production tooling costs. Pursuant to contract provisions of U.S. Government contracts, such customers may have title to, or a security interest in inventories related to such contracts as a result of advances, performance-based payments, and progress payments. The Company reflects those advances and payments as an offset against the related inventory balances.

The Company regularly reviews inventory quantities on hand, future purchase commitments with its suppliers, and the estimated utility of its inventory. If the Company's review indicates a reduction in utility below carrying value, it reduces its inventory to a new cost basis.

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(g) Research and Development

Costs incurred in research and development activities are expensed as incurred in accordance with FASB ASC Topic 730, Research and Development.

(h) Income Taxes

The Company records deferred tax assets and liabilities for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be realized. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date.

The Company maintains a valuation allowance on the deferred tax assets for which it is more likely than not that the Company will not realize the benefits of these tax assets in future tax periods. The valuation allowance is based on estimates of future taxable income by tax jurisdiction in which the Company operates, the number of years over which the deferred tax assets will be recoverable, and scheduled reversals of deferred tax liabilities.

In accordance with the recognition standards established by ASC Topic 740, Income Taxes (“Topic 740”), the Company makes a comprehensive review of its portfolio of uncertain tax positions regularly. In this regard, an uncertain tax position represents the Company's expected treatment of a tax position taken in a filed tax return, or planned to be taken in a future tax return or claim, which has not been reflected in measuring income tax expense for financial reporting purposes. Until these positions are sustained by the taxing authorities, the Company has not recognized the tax benefits resulting from such positions and reports the tax effects as a liability for uncertain tax positions in its Consolidated Balance Sheets.

(i) Stock-Based Compensation

The Company accounts for stock-based compensation in accordance with ASC Topic 718, Compensation-Stock Compensation (“Topic 718”). All of the Company's stock-based compensation plans are considered equity plans under Topic 718, and compensation expense recognized is net of estimated forfeitures over the vesting period. The Company issues stock options and stock awards under its existing plans. The fair value of stock options is estimated on the date of grant using a Black-Scholes option-pricing model or a trinomial lattice options pricing model and is expensed on a straight-line basis over the remaining vesting period of the options, which is generally six or less years. The fair value of stock awards is determined based on the closing market price of the Company's common stock on the grant date and is adjusted at each reporting date based on the amount of shares ultimately expected to vest. Compensation expense for stock awards is expensed over the vesting period, usually five to ten years. Compensation expense for stock issued under the Company's employee stock purchase plan is estimated at the beginning date of the offering period using a Black-Scholes option-pricing model and is expensed on a straight-line basis over the period of the offering, which is generally six months.

For the years ended December 25, 2011, December 30, 2012 and December 29, 2013, there was no incremental tax benefit from stock options exercised in the periods. The Company recorded cash received from the exercise of stock options and awards of $1.3 million in 2011, and $0.0 million in 2012 and in 2013. The following table shows the

amounts recognized in the Consolidated Financial Statements for 2011, 2012 and 2013 for stock-based compensation expense related to stock options, stock awards and to stock offered under the Company's employee stock purchase plan (in millions).

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	2011	2012	2013
Selling, general and administrative expenses	$3.3	$6.6	$7.4
Total cost of employee stock-based compensation included in operating income (loss) from continuing operations, before income tax	3.3	6.6	7.4
Total charged against operations	$3.3	$6.6	$7.4
Impact on net income (loss) per common share:			
Basic and diluted	$(0.12)	$(0.14)	$(0.13)

(j) Allowance for Doubtful Accounts

The Company maintains an allowance for doubtful accounts for estimated losses resulting from the inability of its customers to make required payments, which results in bad debt expense. Management periodically determines the adequacy of this allowance by evaluating the comprehensive risk profiles of all individual customer receivable balances including, but not limited to, the customer's financial condition, credit agency reports, financial statements and overall current economic conditions. Additionally, on certain contracts whereby the Company performs services for a prime/general contractor, a specified percentage of the invoiced trade accounts receivable may be retained by the customer until the project is completed. The Company periodically reviews all retainages for collectability and records allowances for doubtful accounts when deemed appropriate, based on its assessment of the associated credit risks. Changes to estimates of contract value are recorded as adjustments to revenue and not as a component of the allowance for doubtful accounts. Individual accounts receivable are written off to the allowance for doubtful accounts when the Company becomes aware of a specific customer's inability to meet its financial obligation, and all collection efforts are exhausted.

The following table outlines the balance of the Company's Allowance for Doubtful Accounts for 2011, 2012 and 2013. The table identifies the additional provisions each year as well as the write-offs that utilized the allowance (in millions).

Allowance for Doubtful Accounts	Balance at Beginning of Year	Provisions	Write-offs/Recoveries	Balance at End of Year
Year ended December 25, 2011	$0.7	$1.8	$ (0.5)	$2.0
Year ended December 30, 2012	$2.0	$0.4	$ (1.0)	$1.4
Year ended December 29, 2013	$1.4	$1.0	$ (0.2)	$2.2

(k) Cash and Cash Equivalents

The Company's cash equivalents consist of its highly liquid investments with an original maturity of three months or less when purchased by the Company.

The Company has restricted cash accounts of approximately $5.5 million at December 30, 2012 and $5.0 million at December 29, 2013. As of December 30, 2012 and December 29, 2013, restricted cash consists primarily of a deposit securing foreign letters of credit related to payment and performance bonds on international contracts.

(l) Property and Equipment, Net

Property and equipment, net owned by the Company is depreciated over the estimated useful lives of individual assets. Equipment and facilities acquired under capital leases are amortized over the shorter of the lease term or the estimated useful life of the asset. Improvements, which significantly improve and extend the useful life of an asset, are capitalized and depreciated over the shorter of the lease period or the estimated useful life. Expenditures for

maintenance and repairs are charged to operations as incurred.

Assets are depreciated predominately using the straight-line method, with the following lives:

	Years
Buildings and improvements	15 - 39
Machinery and equipment	3 - 10
Computer equipment and software	1 - 10
Vehicles, furniture, and office equipment	5
Leasehold improvements	Shorter of useful life or length of lease

(m) Leases

The Company uses its incremental borrowing rate in the assessment of lease classification as capital or operating and defines the initial lease term to include renewal options determined to be reasonably assured. The Company conducts operations primarily under operating leases.

Most lease agreements for real property contain incentives for tenant improvements, rent holidays, or rent escalation clauses. For incentives for tenant improvements, the Company capitalizes the leasehold improvements which are depreciated over the shorter of the lease term or their estimated useful life and records a deferred rent liability which is amortized over the term of the lease as a reduction to rent expense. For rent holidays and rent escalation clauses during the lease term, the Company records minimum rental expenses on a straight-line basis over the term of the lease. For purposes of recognizing lease incentives, the Company uses the date of initial possession as the commencement date, which is generally when the Company is given the right of access to the space and begins to make improvements in preparation for intended use.

(n) Acquisitions

The Company accounts for business combinations using the acquisition method of accounting as prescribed by ASC Topic 805, Business Combinations (“Topic 805”). The Company allocates the purchase price of its acquisitions to the tangible and intangible assets, and liabilities including certain contingent liabilities acquired based upon their estimated fair values. The excess of purchase price over those fair values is recorded as goodwill. Acquisition-related expenses and restructuring costs are recognized separately from the business combination and are expensed as incurred.

(o) Goodwill and Other Intangible Assets, Net

In accordance with the provisions of ASC Topic 350, Intangibles-Goodwill and Other (“Topic 350”), the Company performs impairment tests for goodwill as of the last day of each fiscal year, or when evidence of potential impairment exists. When it is determined that impairment has occurred, a charge to operations is recorded. Goodwill and other purchased intangible asset balances are included in the identifiable assets of the operating segment to which they have been assigned. Any goodwill impairment, as well as the amortization of other purchased intangible assets, is charged against the respective segments' operating income.

In accordance with Topic 350, the Company classifies intangible assets into three categories: (1) intangible assets with finite lives subject to amortization, (2) intangible assets with indefinite lives not subject to amortization, and (3) goodwill. The Company tests intangible assets with finite lives for impairment if conditions exist that indicate the carrying value may not be recoverable. Such conditions may include an economic downturn in a geographic market or a change in the assessment of future operations. The Company records an impairment charge when the carrying value of the finite lived intangible asset is not recoverable by the cash flows generated from the use of the asset.

The Company determines the useful lives of identifiable intangible assets after considering the specific facts and circumstances related to each intangible asset. Factors considered when determining useful lives include the

contractual term of any agreement, the history of the asset, the Company's long-term strategy for the use of the asset, any laws or other local regulations which could impact the useful life of the asset, and other economic factors, including competition and specific market conditions. Intangible assets that are deemed to have finite lives are amortized, generally on a straight-line basis, over their useful lives, ranging from one to 15 years.

(p) Impairment of Long-Lived Assets and Long-Lived Assets to Be Disposed Of

Long-lived assets and certain identifiable intangibles are reviewed for impairment in accordance with ASC Topic 360, Property, Plant, and Equipment, whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of the assets to future net cash flows (undiscounted and without interest) expected to be generated by the asset. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. Assets to be disposed of are reported at the lower of the carrying amount or fair value less costs to sell.

(q) Fair Value of Financial Instruments

ASC Topic 825, Financial Instruments, requires that fair values be disclosed for the Company's financial instruments. The carrying amounts of cash equivalents, accounts receivable, accounts payable, accrued expenses, billings in excess of costs and earnings on uncompleted contracts, and income taxes payable, approximate fair value due to the short-term nature of these instruments. The fair value of the Company's long-term debt is based upon actual trading activity. The fair value of capital lease obligations is estimated based on quoted market prices for the same or similar obligations with the same remaining maturities.

(r) Concentrations and Uncertainties

The Company maintains cash balances at various financial institutions and such balances commonly exceed the $250,000 insured amount by the Federal Deposit Insurance Corporation. The Company has not experienced any losses in such accounts and management believes that the Company is not exposed to any significant credit risk with respect to such cash and cash equivalents.

Financial instruments, which subject the Company to potential concentrations of credit risk, consist principally of the Company's billed and unbilled accounts receivable. The Company's accounts receivable result from sales to customers within the U.S. Government, state and local agencies and with commercial customers in various industries. The Company performs ongoing credit evaluations of its commercial customers. Credit is extended based on evaluation of the customer's financial condition and collateral is not required. Accounts receivable are recorded at the invoiced amount and do not bear interest. See Note 13 for a discussion of the Company's significant customers.

(s) Debt Issuance Costs

Fees paid to obtain debt financing or amendments under such debt financing are treated as debt issuance costs and are capitalized and amortized over the expected term of the related debt. These payments are shown as a financing activity in the Consolidated Statements of Cash Flows and are included in other current assets and other assets in the Consolidated Balance Sheets.

(t) Interest Expense, Net

Interest expense, net in the Consolidated Statements of Operations and Comprehensive Loss is summarized in the following table (in millions):

	2011	2012	2013
Interest expense incurred primarily on the Company's Senior Secured Notes	$(51.2)	$(66.4)	$(63.9)
Miscellaneous interest income	0.1	0.3	0.2

Interest expense, net	$(51.1)	$(66.1)	$(63.7)

(u) Foreign Currency

For operations outside the U.S. that prepare financial statements in currencies other than the U.S. dollar, results of operations and cash flows are translated at average exchange rates during the period, and assets and liabilities are generally translated at end-of-period exchange rates. Translation adjustments are included as a separate component of accumulated other comprehensive loss in the Consolidated Statements Of Stockholders' Equity.

The Company transacts with foreign customers in currencies other than the U.S. dollar. It experiences realized and unrealized foreign currency gains or losses on foreign denominated receivables. In addition, certain intercompany transactions give rise to realized and unrealized foreign currency gains or losses. Also, any other transactions between the Company or its subsidiaries and a third-party, denominated in a currency different from the functional currency, are foreign currency transactions.

The aggregate foreign currency transaction loss included in determining net loss for the years ended December 25, 2011, December 30, 2012, and December 29, 2013 was approximately $0.5 million, $0.6 million, and $0.0 million, respectively, which is included in other income (expense), net on the accompanying Consolidated Statements of Operations and Comprehensive Loss.

(v) Product Warranties

Certain of the Company's products and services are covered by a warranty to be free from defects in material and workmanship for periods ranging from one to ten years. Optional extended warranty contracts can also be purchased with the revenue deferred and amortized over the extended warranty period. The Company accrues a warranty liability for estimated costs to provide products, parts or services to repair or replace products in satisfaction of warranty obligations. Warranty revenues related to extended warranty contracts are amortized to income, over the life of the contract, using the straight-line method. Costs under extended warranty contracts are expensed as incurred.

The Company's estimate of costs to service its warranty obligations is based upon historical experience and expectations of future conditions. To the extent that the Company experiences any changes in warranty claim activity or costs associated with servicing those claims, its warranty liability is adjusted accordingly.

(x) Recent Accounting Pronouncements

In July 2013, the FASB issued Accounting Standards Update 2013-11 ("ASU 2013-11") "Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists," which states that an unrecognized tax benefit, or a portion of an unrecognized tax benefit, should be presented in the financial statements as a reduction to a deferred tax asset for a net operating loss carryforward, a similar tax loss, or a tax credit carryforward, except as follows. To the extent a net operating loss carryforward, a similar tax loss, or a tax credit carryforward is not available at the reporting date under the tax law of the applicable jurisdiction to settle any additional income taxes that would result from the disallowance of a tax position or the tax law of the applicable jurisdiction does not require the entity to use, and the entity does not intend to use, the deferred tax asset for such purpose, the unrecognized tax benefit should be presented in the financial statements as a liability and should not be combined with deferred tax assets. The amendments in this ASU are effective for fiscal years, and interim periods within those years, beginning after December 15, 2013. The Company does not believe that the adoption of this guidance will have a material impact on its consolidated financial statements.

In February 2013, the FASB issued ASU 2013-02 "Comprehensive Income: Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income," which requires entities to provide information about the amounts reclassified out of accumulated other comprehensive income by component. In addition, entities are required to present, either on the face of the statement where net income is presented or in the notes, significant amounts reclassified out of accumulated other comprehensive income by the respective line items of net income but only if the amount is required under GAAP to be reclassified to net income in its entirety in the same reporting period. For other amounts that are not required under GAAP to be reclassified in their entirety to net income, entities are required to cross-reference to other disclosures required under GAAP that provide additional detail on these amounts. This standard is effective prospectively for reporting periods beginning after December 15, 2012. The Company adopted

this standard in the quarter ended March 31, 2013, which did not have a material impact on its consolidated financial statements.

Note 2. Goodwill and Other Intangible Assets

(a) Goodwill

The Company performs its annual impairment test for goodwill in accordance with Topic 350 as of the last day of each fiscal year or when evidence of potential impairment exists.

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The Company assesses goodwill for impairment at the reporting unit level, which is defined as an operating segment or one level below an operating segment, referred to as a component. The Company determines its reporting units by first identifying its operating segments, and then assessing whether any components of these segments constitute a business for which discrete financial information is available and where segment management regularly reviews the operating results of that component. The Company aggregates components within an operating segment that have similar economic characteristics. For its annual assessments in 2011 and 2012, the Company identified its reporting units to be its KGS and PSS operating segments.

As a result of an internal organizational realignment in August 2013 the Company reorganized its KGS operating segment. As a result of this reorganization, the Company has six divisions comprised of Unmanned Combat Aerial Systems (UCAS) Division, Advanced Drones & Target Systems (ADTS) Division, Modular Systems (MS) Division, Defense and Rocket Support Services (DRSS) Division, Technical and Training Solutions (TTS) Division, and Electronic Products (EP) Division. The Company has identified its reporting units to be the ADTS, DRSS, EP, MS, TTS and UCAS divisions within its KGS reportable segment, and the PSS operating segment to be tested for potential impairment in its fiscal year 2013 annual test.
In order to test for potential impairment, the Company estimates the fair value of each of its reporting units based on a comparison and weighting of the income approach, specifically the discounted cash flow method and the market approach, which estimates the fair value of the Company's reporting units based upon comparable market prices and recent transactions and also validates the reasonableness of the implied multiples from the income approach. The Company reconciles the fair value of its reporting units to its market capitalization by calculating its market capitalization based upon an average of its stock price prior to and subsequent to the date the Company performs its analysis and assuming a control premium. The Company uses these methodologies to determine the fair value of its reporting units for comparison to their corresponding book values because there are no observable inputs available, a Level 3 measurement (See note 10). If the book value exceeds the estimated fair value for a reporting unit a potential impairment is indicated, and Topic 350 prescribes the approach for determining the impairment amount, if any.

As a result of the Company's decision in June 2012 to dispose of certain non-core businesses acquired in the Integral acquisition in July 2011, the Company allocated $1.5 million of goodwill to discontinued operations, which resulted in an impairment charge (see Note 9). The Company then tested the goodwill remaining in the KGS reporting unit. The fair value of the KGS reporting unit exceeded its carrying value by 7.4% at that time.

During the fourth quarter of 2012, the KGS reporting unit was impacted by continued declining market valuations and the economic uncertainty in the U.S. defense industry. Congress was unable to agree on a budget that conformed with the Budget Control Act of 2011 requirements, which called for additional substantial defense spending reductions through sequestration. Congress and the President could not agree on budgetary, tax and spending issues, and as a result a FY 2013 budget was not passed and a six-month continuing resolution that funded the U.S. Government through March 27, 2013 was passed. These events significantly increased the likelihood of the sequester occurring which had negative consequences for the defense industry. In addition, as Congress and the Administration could not come to an agreement on terms of a possible national fiscal approach, they also failed to address other fiscal matters such as the debt ceiling. These events negatively impacted the Company's 2012 annual estimate of the fair value of the KGS reporting unit resulting in the book value of KGS exceeding its fair value in step one of the impairment test.

The Company performed the second step of the goodwill impairment test to measure the amount of the impairment loss, if any, of the KGS reporting unit. The second step of the test requires the allocation of the reporting unit's fair value to its assets and liabilities, including any unrecognized intangible assets, in a hypothetical analysis that calculates the implied fair value of goodwill as if the reporting unit was being acquired in a business combination. If the implied fair value of goodwill is less than the carrying value, the difference is recorded as an impairment loss. Based on the results of the step two analysis, the Company recorded an $82.0 million goodwill impairment in 2012.

As of December 29, 2013, the goodwill of the PSS and KGS reportable segments were $35.6 million and $560.8 million, respectively.

The changes in the carrying amount of goodwill for the years ended December 30, 2012 and December 29, 2013 are as follows (in millions):

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	Public Safety & Security	Kratos Government Solutions	Total
Balance as of December 25, 2011	$33.0	$538.6	$571.6
Additions due to business combinations	2.6	104.3	106.9
Impairments	—	(82.0)	(82.0)
Balance as of December 30, 2012	35.6	560.9	596.5
Retrospective adjustments	—	(0.1)	(0.1)
Balance as of December 30, 2012 after retrospective adjustments	35.6	560.8	596.4
2013 transactions	—	—	—
Balance as of December 29, 2013	$35.6	$560.8	$596.4

The accumulated impairment losses as of December 29, 2013 were $247.4 million, of which $229.1 million was associated with the KGS reportable segment and $18.3 million was associated with the PSS reportable segment.

(b) Purchased Intangible Assets

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

	As of December 30, 2012			As of December 29, 2013		
	Gross Value	Accumulated Amortization	Net Value	Gross Value	Accumulated Amortization	Net Value
Acquired finite-lived intangible assets:						
Customer relationships	$97.7	$(36.2)	$61.5	$97.7	$(53.7)	$44.0
Contracts and backlog	80.0	(64.3)	15.7	80.0	(78.7)	1.3
Developed technology and technical know-how	22.1	(6.4)	15.7	22.1	(8.6)	13.5
Trade names	6.1	(1.2)	4.9	6.1	(3.1)	3.0
Favorable operating lease	1.8	(0.4)	1.4	1.8	(0.6)	1.2
Total finite-lived intangible assets	207.7	(108.5)	99.2	207.7	(144.7)	63.0
Acquired indefinite-lived intangible assets						
Trade names	6.9	—	6.9	6.9	—	6.9
Total indefinite-lived intangible assets	6.9	—	6.9	6.9	—	6.9
Total intangible assets	$214.6	$(108.5)	$106.1	$214.6	$(144.7)	$69.9

The Company reviews intangible assets for impairment whenever events or changes in circumstances indicate that the carrying amount of the asset may not be recoverable. Impairment losses, where identified, are determined as the excess of the carrying value over the estimated fair value of the long-lived asset. The recoverability of the carrying value of assets held for use is assessed based on a review of projected undiscounted cash flows. Prior to conducting step one of the 2012 goodwill impairment test, certain of the long-lived assets were assessed for recoverability. During 2012 the Company made the decision to minimize the use of the CMCI and HBE trade names as part of its overall branding strategy which resulted in a revised fair value of $6.9 million for such trade names, with a remaining useful life of two years. This resulted in an impairment of $14.6 million in 2012. The impairment related to the KGS and PSS reportable segments were $1.7 million and $12.9 million, respectively.

The aggregate amortization expense for finite-lived intangible assets was $38.0 million, $43.9 million and $36.2 million for the years ended December 25, 2011, December 30, 2012, and December 29, 2013, respectively. The Company records all amortization expense in selling, general and administrative expenses in the Consolidated

Statements of Operations and Comprehensive Loss.

The estimated future amortization expense of acquired intangible assets with finite lives as of December 29, 2013 is as follows (in millions):

Fiscal Year	Amount
2014	$21.7
2015	14.4
2016	9.7
2017	8.2
2018	3.9
Thereafter	5.1
Total	$63.0

Note 3. Acquisitions

(a) Summary of Recent Acquisitions

Composite Engineering, Inc.

On July 2, 2012, the Company acquired Composite Engineering, Inc. (“CEI”) for approximately $164.2 million. The purchase price included consideration of $135.0 million in cash and 4.0 million shares of the Company's common stock, valued at $5.94 per share on July 2, 2012, or $23.8 million. As security for CEI's indemnification obligations, $10.7 million of the cash paid was placed into an escrow account. The Company was paid $1.0 million from the escrow account for working capital adjustments in July 2013, at which time the remaining escrow was released to the sellers. Also included in the purchase consideration was $5.5 million paid to retire certain pre-existing CEI debt and settle pre-existing accounts receivable from CEI. There was no contingent purchase consideration associated with the acquisition of CEI.

The Company made an election under Section 338(h)(10) of the Internal Revenue Code, which resulted in tax deductible goodwill related to this transaction. The Company estimated that the tax deductible goodwill and intangibles resulting from the election will approximate $136.3 million, to be available for deduction against Federal and California state income taxes over a 15-year period.

Certain CEI personnel entered into long-term employment agreements with the Company and on July 2, 2012, the Company granted restricted stock units (“RSUs”) for an aggregate 2.0 million shares of common stock as long-term retention inducement grants. The RSUs had an estimated value of $11.9 million on the grant date, vest on the fourth anniversary of the closing of the CEI acquisition, or earlier upon the occurrence of certain events, and are being accounted for as compensation expense over such four-year period.

To fund the acquisition of CEI, on May 14, 2012, the Company sold 20.0 million shares of its common stock at a purchase price of $5.00 per share in an underwritten public offering. The Company received gross proceeds of approximately $100.0 million and net proceeds of approximately $97.0 million after deducting underwriting fees and other offering expenses. The Company used the net proceeds from this offering to fund a portion of the purchase price for the acquisition of CEI. In addition, the Company used borrowings of $40.0 million from its revolving line of credit to partially fund the purchase price of CEI.

CEI is a vertically integrated manufacturer and developer of unmanned aerial target systems and composite structures used for national security programs. Its drones are designed to replicate some of the most lethal aerial threats facing warfighters and strategic assets. CEI's customers include U.S. agencies and foreign governments. CEI is a part of the KGS reportable segment.

The excess of the purchase price over the fair value of the tangible and identifiable intangible assets acquired and liabilities assumed in the acquisition was allocated to goodwill. The value of the goodwill represents the value the Company expects to be created by enabling it to strategically expand its strengths in the areas of design, engineering, development, manufacturing and production of unmanned aerial targets, and by enabling the Company to realize significant cross selling opportunities.

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The transaction was accounted for using the acquisition method of accounting, which requires, among other things, that the assets acquired and liabilities assumed be recognized at their fair values as of the acquisition date. The following table summarizes the fair values of the major assets acquired and liabilities assumed as of the acquisition date (in millions):

Cash	$8.9	
Accounts receivable	9.3	
Inventoried costs	12.3	
Other current assets	8.9	
Property and equipment	8.1	
Intangible assets	38.0	
Goodwill	104.2	
Total assets	189.7	
Current liabilities	(25.7	)
Net assets acquired	$164.0	

The amounts of revenue and operating income of CEI included in the Company's Consolidated Statement of Operations and Comprehensive Income (Loss) for the year ended December 30, 2012 was $68.2 million and $1.6 million, respectively.

Critical Infrastructure Business

On December 30, 2011, the Company acquired selected assets of a critical infrastructure security and public safety system integration business (the “Critical Infrastructure Business”) for approximately $18.8 million.

The Critical Infrastructure Business designs, engineers, deploys, manages and maintains specialty security systems at some of the most strategic asset and critical infrastructure locations in the U.S. Additionally, these security systems are typically integrated into command and control system infrastructure or command centers. Approximately 15% of the revenues of the Critical Infrastructure Business are recurring in nature due to the operation, maintenance or sustainment of the security systems once deployed. The Critical Infrastructure Business is part of the Company's PSS reportable segment.

The excess of the purchase price over the fair value of the tangible and identifiable intangible assets acquired and liabilities assumed in the acquisition was allocated to goodwill. The value of the goodwill represents the value the Company expects to be created by enabling it to strategically expand its strengths in the areas of homeland security solutions and will also enable the Company to realize significant cross selling opportunities and increase its sales of higher margin, fixed-price products.

The transaction was accounted for using the acquisition method of accounting, which requires, among other things, that the assets acquired and liabilities assumed be recognized at their fair values as of the acquisition date. The following table summarizes the fair values of the major assets acquired and liabilities assumed as of the acquisition date (in millions):

Accounts receivable	$23.4	
Other assets	0.5	
Intangible assets	2.0	
Goodwill	2.6	
Total assets	28.5	
Current liabilities	(9.7	)

Net assets acquired	$18.8

The goodwill recorded in this transaction is tax deductible.

SecureInfo Corporation

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On November 15, 2011, the Company acquired SecureInfo Corporation ("SecureInfo") for $20.3 million in cash, which included a $1.5 million earn-out that was paid in March 2012.

Based in northern Virginia, SecureInfo is a cybersecurity company specializing in assisting defense, intelligence, civilian government and commercial customers to identify, understand, document, manage, mitigate and protect against cybersecurity risks while reducing information security costs and achieving compliance with applicable regulations, standards and guidance. SecureInfo offers strategic advisory, operational cybersecurity and cybersecurity risk management services and is a recognized leader in the rapidly evolving fields of cloud security, continuous monitoring and cybersecurity training. Customers include the Department of Defense, the Department of Homeland Security and large commercial customers, including market leading cloud computing service providers. SecureInfo is part of the KGS reportable segment.

The excess of the purchase price over the fair value of the tangible and identifiable intangible assets acquired and liabilities assumed in the acquisition was allocated to goodwill. The value of the goodwill represents the value the Company expects to be created by SecureInfo's nationally recognized expertise in operational cybersecurity, cybersecurity risk management and cybersecurity training programs.

The SecureInfo transaction has been accounted for using the acquisition method of accounting, which requires, among other things, that the assets acquired and liabilities assumed be recognized at their fair values as of the acquisition date. The following table summarizes the estimated fair values of the major assets acquired and liabilities assumed (in millions):

Cash	$1.4	
Other assets	3.0	
Property and equipment	0.1	
Intangible assets	4.5	
Goodwill	12.2	
Total assets	21.2	
Current liabilities	(0.9	)
Net assets acquired	$20.3	

The goodwill recorded in this transaction is not tax deductible.

The amounts of revenue and operating income of SecureInfo included in the Company's Consolidated Statement of Operations and Comprehensive Income (Loss) for the year ended December 25, 2011 was $1.9 million and $0.1 million, respectively.

Integral Systems, Inc.

On July 27, 2011, the Company acquired Integral Systems, Inc. ("Integral") in a cash and stock transaction valued at $241.1 million. Upon completion of the acquisition, the Company paid an aggregate of $131.4 million in cash, issued approximately 10.4 million shares of the Company's common stock valued at $108.7 million and issued replacement stock options with a fair value of $1.0 million.

To fund the cash portion of the acquisition, on July 27, 2011, the Company issued $115.0 million aggregate principal amount of 10% Senior Secured Notes due 2017 (the "Notes"). The Notes were issued at a premium of 105% for an effective interest rate of approximately 8.9%. The gross proceeds of approximately $120.8 million, which included an approximate $5.8 million issuance premium and excluded accrued interest received of $1.8 million, were used to finance, in part, the cash portion of the purchase price for the acquisition of Integral, to refinance existing

indebtedness of Integral and its subsidiaries, to pay certain severance payments in connection with the acquisition and to pay related fees and expenses.

As consideration for the acquisition of Integral, each Integral stockholder received (i) $5.00 in cash, without interest, and (ii) 0.588 shares of the Company's common stock for each share of Integral common stock. In addition, upon completion of the acquisition (i) each outstanding Integral stock option with an exercise price less than $13.00 per share was, if the holder thereof had so elected in writing, canceled in exchange for an amount in cash equal to the product of the total number of shares of Integral common stock subject to such in-the-money option, multiplied by the aggregate value of the excess, if any, of $13.00 over the exercise price per share applicable to such option, less the amount of any tax withholding, (ii) each outstanding Integral stock option with an exercise price equal to or greater than $13.00 per share and each Integral in-the-money option the

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holder of which had not made the election described in (i) above was converted into an option to purchase Company common stock, with the number of shares subject to such option adjusted to equal the number of shares of Integral common stock subject to such out-of-the-money option multiplied by 0.9559, rounded up to the nearest whole share, and the per share exercise price under each such option adjusted by dividing the per share exercise price applicable to such option by 0.9559, rounded up to the nearest whole cent, and (iii) each outstanding share of restricted stock granted under an Integral equity plan or otherwise, whether vested or unvested, was canceled and converted into the right to receive $13.00, less the amount of any tax withholding.

Integral is a global provider of products, systems and services for satellite command and control, telemetry and digital signal processing, data communications, enterprise network management and communications information assurance. Integral specializes in developing, managing and operating secure communications networks, both satellite and terrestrial, as well as systems and services to detect, characterize and geolocate sources of radio frequency or RF interference. Integral's customers include U.S. and foreign commercial, government, military and intelligence organizations. For almost 30 years, customers have relied on Integral to design and deliver innovative commercial-based products, solutions and services that are cost-effective and reduce delivery schedules and risk. Integral is part of the Company's KGS reportable segment.

The excess of the purchase price over the fair value of the tangible and identifiable intangible assets acquired and liabilities assumed in the acquisition was allocated to goodwill. The value of the goodwill represents the value the Company expects to be created by Integral's significant expertise with satellite operations, ground systems, signal processing and other areas of satellite command and control, as well as advanced technologies for Unmanned Aerial Vehicles, situational awareness, remote management and numerous established electronic attack and electronic warfare platforms, tactical missile systems, and strategic deterrence systems. The Integral transaction has been accounted for using the acquisition method of accounting which requires, among other things, that the assets acquired and liabilities assumed be recognized at their fair values as of the merger date. The following table summarizes the fair values of the major assets acquired and liabilities assumed as of July 27, 2011 (in millions):

Cash	$6.8	
Accounts receivable	68.4	
Inventoried costs	15.8	
Deferred tax assets	36.4	
Other assets	3.5	
Property and equipment	12.9	
Intangible assets	32.0	
Goodwill	187.8	
Total assets	363.6	
Current liabilities	(84.5	)
Deferred tax liabilities	(19.5	)
Long-term liabilities	(18.5	)
Net assets acquired	$241.1	

The goodwill recorded in this transaction is not tax deductible.

The amounts of revenue and operating income of Integral included in the Company's Consolidated Statements of Operations and Comprehensive Income for the year ended December 25, 2011 was $87.3 million and $7.1 million, respectively.

Herley Industries, Inc.

On March 25, 2011, the Company acquired approximately 13.2 million shares of Herley Industries, Inc. ("Herley") common stock, representing approximately 94% of the total outstanding shares of Herley common stock, in a tender offer to purchase all of the outstanding shares of Herley common stock. The fair value of the non-controlling interest related to Herley as of March 25, 2011 was $16.9 million, which represents the market trading price of $19.00 per share multiplied by approximately 0.9 million shares that were not tendered as of March 25, 2011. On March 30, 2011, following the purchase of the non-controlling interest in a subsequent offering period, Herley became a wholly owned subsidiary of the Company. The shares of Herley common stock were purchased at a price of $19.00 per share. Accordingly, the Company paid approximately $245.5 million in cash consideration as of March 27, 2011, and as of April 15, 2011 the Company had paid aggregate cash

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consideration of $270.7 million for the shares of Herley common stock and certain in-the-money options, which were exercised upon the change in control. In addition, upon completion of the subsequent short-form merger, all unexercised options to purchase Herley common stock were assumed by the Company and converted into options to purchase Kratos common stock, entitling the holders thereof to receive 1.3495 shares of Kratos common stock for each share of Herley common stock underlying the options (“Herley Options”). The Company assumed each Herley Option in accordance with the terms (as in effect as of the date of the Herley Merger Agreement) of the applicable Herley equity plan and the option agreement pursuant to which such Herley Option was granted. The Herley Options are exercisable for an aggregate of approximately 0.8 million shares of the Company’s common stock. All Herley Options were fully vested upon the change in control, and the fair value of the Herley Options assumed was $1.9 million. The total aggregate consideration for the purchase of Herley was $272.5 million, including the assumed Herley Options. In addition, the Company assumed change in control obligations of $4.0 million related to the transaction and incurred combined transaction expenses of $11.1 million. There were no contingent liabilities associated with the acquisition of Herley.

To fund the acquisition of Herley, on February 11, 2011, Kratos sold approximately 4.9 million shares of its common stock at a purchase price of $13.25 per share in an underwritten public offering. Kratos received gross proceeds of approximately $64.8 million and net proceeds of approximately $61.1 million after deducting underwriting fees and other offering expenses. Kratos used the net proceeds from this offering to fund a portion of the purchase price for the acquisition of Herley. To fund the remaining purchase price, Kratos issued $285.0 million in aggregate principal amount of Notes at a premium of 107% through its wholly owned subsidiary, Acquisition Co. Lanza Parent ("Lanza"), on March 25, 2011, in an unregistered offering pursuant to Rule 144A and Regulation S under the Securities Act of 1933, as amended. On April 4, 2011, after the acquisition of Herley was complete, Lanza was merged with and into Kratos and all assets and liabilities of Lanza became assets and liabilities of Kratos.

Herley is a leading provider of microwave technologies for use in command and control systems, flight instrumentation, weapons sensors, radar, communication systems, electronic warfare and electronic attack systems. Herley has served the defense industry for approximately 45 years by designing and manufacturing microwave devices for use in high-technology defense electronics applications. It has established relationships, experience and expertise in the military electronics, electronic warfare and electronic attack industry. 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/cyber security applications. Herley is part of the KGS reportable segment.

The excess of the purchase price over the fair value of the tangible and identifiable intangible assets acquired and liabilities assumed in the acquisition was allocated to goodwill. The value of the goodwill represents the value the Company expects to be created by Herley’s significant expertise in numerous established electronic attack and electronic warfare platforms, tactical missile systems, and strategic deterrence systems, which complement the Company’s existing business in manned and unmanned aircraft, missile systems and certain other programs.

The Herley transaction has been accounted for using the acquisition method of accounting, which requires, among other things, that the assets acquired and liabilities assumed be recognized at their fair values as of the merger date. The following table summarizes the fair values of the major assets acquired and liabilities assumed (in millions):

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Cash	$21.8
Accounts receivable	39.1
Inventoried costs	42.8
Deferred tax assets	17.3
Other assets	7.2
Property and equipment	34.2
Intangible assets	37.0
Goodwill	146.4
Total assets	345.8
Current liabilities	(40.8)
Deferred tax liabilities	(16.8)
Debt	(9.5)
Long-term liabilities	(6.2)
Net assets acquired	$272.5

The goodwill recorded in this transaction is not tax deductible.

The amounts of revenue and operating income of Herley included in the Company's Consolidated Statements of Operations and Comprehensive Income for the year ended December 25, 2011 was $150.8 million and $12.7 million, respectively.

Pro Forma Financial Information

The following tables summarize the supplemental Condensed Consolidated Statements of Operations information on an unaudited pro forma basis as if the acquisitions of CEI, the Critical Infrastructure Business, SecureInfo, Integral, and Herley occurred on December 27, 2010 and include adjustments that were directly attributable to the foregoing transactions or were not expected to have a continuing impact on the Company. All acquisitions were included in the results of operations for the full year ended December 29, 2013. There are no material, nonrecurring pro forma adjustments directly attributable to the business combinations included in the reported pro forma revenue and operations for 2011 and 2012. The pro forma results are for illustrative purposes only for the applicable period and do not purport to be indicative of the actual results that would have occurred had the transactions been completed as of the beginning of the period, nor are they indicative of results of operations that may occur in the future (all amounts, except per share amounts are in millions):

	Year Ended December 25, 2011	Year Ended December 30, 2012
Pro forma revenues	$1,046.9	$1,019.5
Pro forma net loss before tax	(63.6)	(132.0)
Pro forma net loss	(67.1)	(130.4)
Net loss attributable to the registrant	(23.5)	(112.9)
Basic and diluted pro forma loss per share	$(1.15)	$(2.31)

The pro forma financial information reflects acquisition related expenses incurred, pro forma adjustments for the additional amortization associated with finite-lived intangible assets acquired, additional incremental interest expense, deferred financing costs related to the financing undertaken for the Integral and Herley transactions, the change in stock compensation expense as a result of the exercise of stock options and restricted stock immediately prior to closing of the Integral and Herley transactions, stock compensation related to the RSUs granted in the CEI transaction, and the related tax expense. The weighted average common shares also reflect the issuance of 4.9 million shares in

February 2011 for the Herley acquisitions and 10.4 million shares in July 2011 for the Integral acquisition.

These adjustments are as follows (in millions except per share data):

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	Year Ended December 25, 2011	Year Ended December 30, 2012
Intangible amortization	$32.8	$16.2
Net change in stock compensation expense	(1.4)	2.2
Net change in interest expense	(9.9)	—
Net change in income tax expense	(1.6)	—
Increase in weighted average common shares outstanding for shares issued and not already included in the weighted average common shares outstanding	30.7	9.6

Contingent Acquisition Consideration

In connection with certain acquisitions, the Company has agreed to make additional future payments to the seller contingent upon achievement of specific performance-based milestones by the acquired entities. Pursuant to the provisions of Topic 805, the Company re-measures these liabilities each reporting period and records changes in the fair value in its Consolidated Statement of Operations and Comprehensive Income (Loss). Increases or decreases in the fair value of the contingent consideration liability which is measured as the present value of expected future cash flows, a Level 3 (Level 3 hierarchy as defined by ASC Topic 820, Fair Value Measurements and Disclosures (“Topic 820”)) measurement in the fair value hierarchy, can result from changes in discount periods and rates, as well as changes in the estimates on the achievement of the performance-based milestones.

Contingent acquisition consideration as of December 30, 2012 and December 29, 2013 is summarized in the following table (in millions):

	SecureInfo	DEI	SCT	Total
Balance as of December 25, 2011	$1.5	$5.0	$1.1	$7.6
Cash payments	(1.5)	(2.5)	—	(4.0)
Post acquisition adjustments reflected in operating results	—	(0.4)	(1.1)	(1.5)
Balance as of December 30, 2012	—	2.1	—	2.1
Cash payments	—	(2.1)	—	(2.1)
Balance as of December 29, 2013	$—	$—	$—	$—

Pursuant to the terms of the agreement and plan of merger with DEI Services Corporation entered into on August 9, 2010 (“the DEI Agreement”), upon achievement of certain cash receipts, revenue, EBITDA and backlog amounts in 2010, 2011 and 2012, the Company was obligated to pay certain additional contingent consideration (the “DEI Contingent Consideration”). The Company has paid $5.0 million related to the DEI Contingent Consideration, with the final payment of $2.1 million paid in April 2013.

As of December 25, 2011, the fair value of the SCT Contingent Consideration was $1.1 million and was estimated by applying the income approach, which is based on significant inputs that are not observable in the market, which Topic 820 refers to as Level 3 inputs. Key assumptions included a discount rate of 6.1%, a market participant cost of debt at the date of acquisition, and probability-adjusted levels for EBITDA. The fair value of the SCT Contingent Consideration was decreased by $1.1 million to zero and recognized as a credit to merger and acquisition related items during the three month period ended December 30, 2012.

Note 4. Balance Sheet Details

The detail of certain assets in the Consolidated Balance Sheets consists of the following (in millions).

Cash and cash equivalents

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The Company's cash equivalents consist of overnight cash sweep accounts that are invested on a daily basis. Cash and cash equivalents at December 30, 2012 and December 29, 2013 were $49.0 million and $55.7 million, respectively and approximated their fair value.

Net unrealized and realized gains recorded during the years ended December 30, 2012 and December 29, 2013 were immaterial.

Accounts receivable, net

Receivables including amounts due under long-term contracts are summarized as follows:

	December 30, 2012	December 29, 2013
Billed, current	$137.9	$150.2
Unbilled, current	135.4	117.9
Total current accounts receivable	273.3	268.1
Allowance for doubtful accounts	(1.4)	(2.3)
Total current accounts receivable, net	271.9	265.8
Unbilled, long-term (included in other assets)	0.3	0.1
Total accounts receivable, net	$272.2	$265.9

Unbilled receivables represent the balance of recoverable costs and accrued profit, composed principally of revenue recognized on contracts for which billings have not been presented to the customer because the amounts were earned but not contractually billable as of the balance sheet date. Retainages receivable were $3.5 million as of December 30, 2012 and $6.2 million as of December 29, 2013 and are included in accounts receivable, net in the Consolidated Balance Sheets.

U.S. Government contract receivables (included in accounts receivable, net)

	December 30, 2012	December 29, 2013
Billed	$24.6	$19.8
Unbilled	39.4	31.6
Total U.S. Government contract receivables	$64.0	$51.4

Inventoried costs, net of progress payments

	December 30, 2012	December 29, 2013
Raw materials	$48.4	$44.5
Work in process	36.5	24.3
Finished goods	7.3	4.6
Supplies and other	2.2	1.9
Subtotal inventoried costs	94.4	75.3
Less customer advances and progress payments	(0.1)	(0.7)
Total inventoried costs	$94.3	$74.6

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Property and equipment, net

	December 30, 2012	December 29, 2013
Land and buildings	$20.8	$21.0
Computer equipment and software	17.2	20.0
Machinery and equipment	49.9	59.0
Furniture and office equipment	12.2	15.4
Facility under capital lease	1.0	1.0
Leasehold improvements	13.9	13.7
Construction in progress	5.8	4.8
Property and equipment	120.8	134.9
Accumulated depreciation and amortization	(35.2)	(50.1)
Total property and equipment, net	$85.6	$84.8

Depreciation expense was $10.0 million, $14.1 million and $17.2 million for the years ended December 25, 2011, December 30, 2012, and December 29, 2013, respectively.

Note 5. Debt

(a) Issuance of 10% Senior Secured Notes due 2017

On May 19, 2010, the Company entered into an indenture with the guarantors set forth therein and Wilmington Trust FSB, as trustee and collateral agent (as amended or supplemented the “Indenture”), to issue the Notes. As of December 29, 2013, the Company had issued Notes in the aggregate principal amount of $625.0 million under the Indenture, of which $225.0 million were issued on May 19, 2010, $285.0 million were issued on March 25, 2011 at a $20.0 million premium and an effective interest rate of 8.5%, and $115.0 million were issued on July 27, 2011 at a $5.8 million premium and an effective interest rate of 8.9%. These Notes have been used to fund acquisitions and for general corporate purposes. The holders of the Notes have a first priority lien on substantially all of the Company's assets and the assets of the guarantors, except with respect to accounts receivable, inventory, deposit accounts, securities accounts, cash, securities and general intangibles (other than intellectual property), on which the holders of the Notes have a second priority lien to the $110.0 million credit facility described below.

The Company pays interest on the Notes semi-annually, in arrears, on June 1 and December 1 of each year. The Notes include customary covenants and events of default as well as a consolidated fixed charge ratio of 2:1 for the incurrence of additional indebtedness. Negative covenants include, among other things, limitations on additional debt, liens, negative pledges, investments, dividends, stock repurchases, asset sales and affiliate transactions. Events of default include, among other events, non-performance of covenants, breach of representations, cross-default to other material debt, bankruptcy, insolvency, material judgments and changes in control. As of December 29, 2013, the Company was in compliance with the covenants contained in the Indenture governing the Notes. In addition, the ability to pay dividends is restricted by both the indenture entered into in connection with the issuance of the Notes due 2017 and the amended credit and security agreement discussed below.

On or after June 1, 2014, the Company may redeem some or all of the Notes at 105% of the aggregate principal amount of such notes through June 1, 2015, 102.5% of the aggregate principal amount of such notes through June 1, 2016 and 100% of the aggregate principal amount of such notes thereafter, plus accrued and unpaid interest to the date of redemption. In addition, the Company may, at its option, redeem some or all of the Notes at any time prior to June 1, 2014 by paying a “make whole” premium, plus accrued and unpaid interest, if any, to the date of redemption. The Company may also purchase outstanding Notes traded on the open market at any time.

The Notes were issued in three offerings.

$225 million 10% Senior Secured Note Offering, May 2010

On May 19, 2010, the Company issued Notes in the aggregate principal amount of $225.0 million in an unregistered offering pursuant to Rule 144A and Regulation S under the Securities Act, and on August 11, 2010, the Company completed an

exchange offer for such Notes pursuant to a registration rights agreement entered into in connection with the issuance thereof. The proceeds were primarily used to finance the acquisitions of Gichner Holdings, Inc., DEI Services Corporation, and Southside Container & Trailer, LLC, as well as to refinance the Company's existing debt.

$285 million 10% Senior Secured Note Offering, March 2011

On March 25, 2011, the Company issued Notes in the aggregate principal amount of $285.0 million in an unregistered offering pursuant to Rule 144A and Regulation S under the Securities Act and received approximately $314.0 million in cash proceeds from the offering, which includes an approximate $20.0 million of issuance premiums and $9.0 million of accrued interest, which proceeds were used, together with cash contributions of $45.0 million from the Company, to finance the acquisition of all of the outstanding shares of common stock of Herley (see Note 3), to pay related fees and expenses and for general corporate purposes. The effective interest rate on this issuance was 8.5%. On July 29, 2011, the Company completed an exchange offer for these Notes pursuant to a registration rights agreement entered into in connection with this issuance.

$115 million 10% Senior Secured Note Offering, July 2011

On July 27, 2011, the Company issued Notes in the aggregate principal amount of $115.0 million in an unregistered offering pursuant to Rule 144A and Regulation S under the Securities Act and received approximately $122.5 million in cash proceeds from the issuance of the Notes, which includes an approximate $5.8 million of issuance premiums and $1.7 million of accrued interest. These proceeds were used to finance, in part, the cash portion of the purchase price for the acquisition of Integral (see Note 3), to refinance existing indebtedness of Integral, to make certain severance payments in connection with the acquisition of Integral and to pay related fees and expenses. The effective interest rate on this issuance was 8.9%. On December 2, 2011, the Company completed an exchange offer for these Notes pursuant to a registration rights agreement entered into in connection with this issuance.

(b) Other Indebtedness

$110.0 Million Credit Facility

On July 27, 2011, the Company entered into a credit and security agreement with KeyBank National Association (“KeyBank”), as lead arranger, sole book runner and administrative agent, and East West Bank and Bank of the West, as the lenders (the “2011 Credit Agreement”). The 2011 Credit Agreement amends and restates in its entirety the credit and security agreement, dated as of May 19, 2010, by and among the Company, KeyBank and the lenders named therein (as amended). The 2011 Credit Agreement established a five-year senior secured revolving credit facility in the amount of $65.0 million (as amended and described below, the “Amended Revolver”). The Amended Revolver is secured by a lien on substantially all of the Company's assets and the assets of the guarantors thereunder, subject to certain exceptions and permitted liens. The Amended Revolver has a first priority lien on accounts receivable, inventory, deposit accounts, securities accounts, cash, securities and general intangibles (other than intellectual property). On all other assets, the Amended Revolver has a second priority lien junior to the lien securing the Notes.

Borrowings under the Amended Revolver are subject to mandatory prepayment upon the occurrence of certain events, including the issuance of certain securities, the incurrence of certain debt and the sale or other disposition of certain assets. The Amended Revolver includes customary affirmative and negative covenants and events of default, as well as a financial covenant relating to a minimum fixed charge coverage ratio of 1.25. Negative covenants include, among other things, limitations on additional debt, liens, negative pledges, investments, dividends, stock repurchases, asset sales and affiliate transactions. Events of default include, among other events, non-performance of covenants, breach of representations, cross-default to other material debt, bankruptcy and insolvency, material judgments and changes in

control.

On November 14, 2011, the Company entered into a first amendment (the “First Amendment”) to the 2011 Credit Agreement. Among other things, the First Amendment: (i) increased the amount of the Amended Revolver from $65.0 million to $90.0 million; (ii) added to and modified the definitions of certain terms contained in the 2011 Credit Agreement; (iii) added PNC Bank, National Association as a lender under the 2011 Credit Agreement; and (iv) updated certain schedules to the 2011 Credit Agreement.

On May 4, 2012, the Company entered into a second amendment (the “Second Amendment”) to the 2011 Credit Agreement. Among other things, the Second Amendment (i) increased the amount of the Amended Revolver from $90.0 million to $110.0 million; (ii) added to and modified the definitions of certain terms contained in the 2011 Credit Agreement; (iii) added Cathay Bank as a lender under the 2011 Credit Agreement; (iv) increased the maximum available to be borrowed

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under the 2011 Credit Agreement to $135.0 million subject to KeyBank's approval; and (v) updated certain schedules to the Credit Agreement.

On May 8, 2012, the Company entered into a third amendment (the “Third Amendment”) to the 2011 Credit Agreement. Under the terms of the Third Amendment, the definitions of certain terms of the 2011 Credit Agreement were modified and the acquisition of CEI was approved. The Company used the net proceeds from the sale of 20.0 million shares of its common stock, together with the borrowings under its credit facility, to fund the purchase of CEI on July 2, 2012 and to pay related fees and expenses.

The amounts of borrowings that may be made under the Amended Revolver are based on a borrowing base and are comprised of specified percentages of eligible receivables, eligible unbilled receivables and eligible inventory. If the amount of borrowings outstanding under the Amended Revolver exceeds the borrowing base then in effect, the Company is required to repay such borrowings in an amount sufficient to eliminate such excess. The Amended Revolver includes $50.0 million of availability for letters of credit and $10.0 million of availability for swing line loans.

The Company may borrow funds under the Amended Revolver at a rate based either on LIBOR or a base rate established by KeyBank. Base rate borrowings bear interest at an applicable margin of 1.00% to 1.75% over the base rate (which will be the greater of the prime rate or 0.5% over the federal funds rate, with a floor of 1.0% over one month LIBOR). LIBOR rate borrowings will bear interest at an applicable margin of 3.00% to 3.75% over the LIBOR rate. The applicable margin for base rate borrowings and LIBOR borrowings will depend on the average monthly revolving credit availability. The Amended Revolver also has a commitment fee of 0.50% to 0.75%, depending on the average monthly revolving credit availability. As of December 29, 2013, there were no outstanding borrowings on the Amended Revolver and $10.7 million was outstanding on letters of credit resulting in net borrowing base availability of $79.9 million. The Company was in compliance with the financial covenants as of December 29, 2013.

Debt Acquired in Acquisition of Herley

The Company assumed a $10.0 million 10-year term loan with a bank in Israel that Herley entered into on September 16, 2008 in connection with the acquisition of Herley. The balance as of December 29, 2013 was $4.8 million, and the loan is payable in quarterly installments of $0.3 million plus interest at LIBOR plus a margin of 1.5%. The loan agreement contains various covenants, including a minimum net equity covenant as defined in the loan agreement. The Company was in compliance with all covenants, as of December 29, 2013.

Fair Value of Long-term Debt

Carrying amounts and the related estimated fair values of the Company’s long-term debt financial instruments not measured at fair value on a recurring basis at December 30, 2012 and December 29, 2013 are presented in the following table:

	As of December 30, 2012			As of December 29, 2013		
$ in millions	Principal	Carrying Amount	Fair Value	Principal	Carrying Amount	Fair Value
Long-term debt	$630.7	$649.4	$690.5	$629.8	$644.3	$679.7

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

The net unamortized debt premium of $14.5 million as of December 29, 2013, which is the difference between the carrying amount of $644.3 million and the principal amount of $629.8 million represented in the previous table, is being amortized to interest expense over the terms of the related debt.

Future maturities of long-term debt for each of the years ending 2014 through 2016 are $1.0 million per year, $626.0 million in 2017, and $0.8 million in 2018.

Note 6. Lease Commitments

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The Company leases certain facilities and equipment under operating and capital leases having terms expiring at various dates through 2023.

Future minimum lease payments under capital and operating leases as of December 29, 2013, which does not include $7.1 million in sublease income on the Company's operating leases, are as follows (in millions):

Year	Capital Leases	Net Operating Leases
2014	$0.4	$15.9
2015	0.1	13.0
2016	—	10.9
2017	—	9.6
2018	—	8.8
Thereafter	—	12.7
Total future minimum lease payments	0.5	$70.9
Less amount representing interest	0.1	
Present value of capital lease obligations	0.4	
Less current portion	0.3	
Long-term capital lease obligations	$0.1	

The following is an analysis of the leased property under capital leases by major class (in millions):

	December 30, 2012	December 29, 2013
Classes of Property		
Facilities	$1.0	$1.0
Vehicles	0.5	0.5
Office equipment	0.5	0.4
Total	2	1.9
Less: Accumulated amortization	1.5	1.7
	$0.5	$0.2

Amortization expense related to capital leases was $0.1 million, $0.1 million and $0.2 million for the years ended December 25, 2011, December 30, 2012 and December 29, 2013, respectively.

Gross rent expense under operating leases for the years ended December 25, 2011, December 30, 2012, and December 29, 2013 was $12.8 million, $21.1 million, and $16.7 million, respectively. Total sublease income for the years ended December 25, 2011, December 30, 2012, and December 29, 2013, totaling $1.3 million, $2.7 million, and $2.3 million, respectively, has been netted against rent expense.

Based on management's assessment of assumptions considering existing market conditions, sublease rental rates and recoverability of operating lease expenses for the Company's vacant properties and due to the Company's actions to consolidate facilities, the Company periodically reevaluates its accrual for excess facilities. In 2011, as a result of the Integral acquisition, the Company acquired 131,450 rentable square feet of property located in Maryland with a lease term through April 2020. Prior to the acquisition, Integral had vacated the majority of this space and subleased approximately 83,000 square feet for an initial term which commenced on October 1, 2010 and ends on October 31, 2015. The Company recorded a liability at fair value of approximately $19.0 million at the merger date related to this excess facility.

The Company's accrual for excess facilities was $18.5 million, $18.7 million, and $12.4 million as of December 25, 2011, December 30, 2012 and December 29, 2013, respectively. The Company estimates that the remaining accrual will be paid through 2020.

The accrual for excess facilities is as follows (in millions):

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	Excess Facilities
Balance as of December 25, 2011	$18.5
Fair value of liability assumed in acquisition	1.8
Cash payments	(1.6)
Balance as of December 30, 2012	18.7
Adjustments of excess facility accruals	(4.7)
Cash payments	(1.6)
Balance as of December 29, 2013	$12.4

The lease on certain office facilities includes scheduled base rent increases over the term of the lease. The total amount of the base rent payments is being charged to expense on the straight-line method over the term of the lease. In addition to the base rent payment, the Company pays a monthly allocation of the building's operating expenses. The Company has recorded deferred rent, included in accrued expenses and other long-term liabilities in the Consolidated Balance Sheets, of $1.0 million, $1.3 million, and $3.2 million at December 25, 2011, December 30, 2012 and December 29, 2013, respectively, to reflect the excess of rent expense over cash payments since inception of the respective leases. The adjustment to the accrual in 2013 was primarily due to a change in the necessary estimated excess facility accrual of office space at our Colombia, Maryland administrative facilities.

Note 7. Net Loss Per Common Share

The Company calculates net income (loss) per share in accordance with FASB ASC Topic 260, Earnings per Share ("Topic 260"). Under Topic 260, basic net income (loss) per common share is calculated by dividing net income (loss) by the weighted-average number of common shares outstanding during the reporting period. Diluted net income (loss) per common share reflects the effects of potentially dilutive securities.

The following shares were excluded from the calculation of diluted loss per share because their inclusion would have been anti-dilutive (in millions):

	December 25, 2011	December 30, 2012	December 29, 2013
Shares from stock options and awards	2.1	3.6	2.6

Note 8. Income Taxes

The components of income (loss) from continuing operations before income taxes and equity earnings are listed below (in millions):

	2011	2012	2013
Domestic	$(20.7)	$(120.3)	$(39.4)
Foreign	(0.9)	5.8	7.5
Total	$(21.6)	$(114.5)	$(31.9)

The provision (benefit) for income taxes from continuing operations for the years ended December 25, 2011, December 30, 2012, and December 29, 2013 are comprised of the following (in millions):

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	2011	2012	2013
Federal income taxes:			
Current	$(1.5)	$—	$(1.7)
Deferred	0.6	(3.5)	0.3
Total Federal	(0.9)	(3.5)	(1.4)
State and local income taxes			
Current	3.1	0.8	2.0
Deferred	0.8	0.4	(0.7)
Total State and local	3.9	1.2	1.3
Foreign income taxes:			
Current	0.4	0.1	0.1
Deferred	(1.5)	0.6	—
Total Foreign	(1.1)	0.7	0.1
Total	$1.9	$(1.6)	$—

A reconciliation of the total income tax provision (benefit) to the amount computed by applying the statutory federal income tax rate of 35% to income (loss) from continuing operations before income tax provision for the years ended December 25, 2011, December 30, 2012 and December 29, 2013 is as follows (in millions):

	2011	2012	2013
Income tax expense (benefit) at federal statutory rate	$(7.6)	$(40.1)	$(11.1)
State taxes, net of federal tax benefit and valuation allowance	3.1	0.7	1.8
Difference in tax rates between U.S. and foreign	(0.1)	(1.5)	(2.6)
Release of foreign valuation allowance	(0.7)	—	—
Increase (decrease) in federal valuation allowance	4.7	14.2	13.0
Nondeductible expense	0.4	0.3	0.7
Increase (decrease) in reserve for uncertain tax positions	(1.7)	0.1	(1.4)
Transaction costs	2.3	0.1	—
Changes to indefinite life items and separate state deferred taxes	1.5	(3.0)	(0.4)
Impact of purchase accounting	—	—	—
Goodwill impairment	—	27.6	—
Total	$1.9	$(1.6)	$—

The tax effects of temporary differences that give rise to the deferred tax assets and deferred tax liabilities as of December 30, 2012 and December 29, 2013 are as follows (in millions):

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	2012	2013
Deferred tax assets:		
Allowance for doubtful accounts	$0.4	$0.7
Sundry accruals	3.3	2.8
Vacation accrual	5.1	5.2
Stock-based compensation	4.6	6.1
Payroll related accruals	2.7	3.3
Lease accruals	9.7	9.1
Investments	1.9	1.9
Net operating loss carryforwards	124.8	118.2
Tax credit carryforwards	3.7	5.1
Deferred revenue	2.1	2.4
Reserves and other	10.2	10.2
	168.5	165
Valuation allowance	(110.4)	(123.1)
Total deferred tax assets, net of allowance	58.1	41.9
Deferred tax liabilities:		
Unearned revenue	(42.0)	(35.8)
Other intangibles	(15.7)	(4.7)
Property and equipment, principally due to differences in depreciation	(7.9)	(7.7)
Other	—	(0.9)
Total deferred tax liabilities	(65.6)	(49.1)
Net deferred tax asset (liability)	$(7.5)	$(7.2)

In assessing the Company's ability to realize deferred tax assets, management considers, on a periodic basis, whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. As such, management has determined that it is appropriate to maintain a full valuation allowance against the Company's deferred tax assets, with the exception of an amount equal to its deferred tax liabilities, which can be expected to reverse over a definite life and certain foreign and separate state deferred tax assets. Management will continue to evaluate the necessity to maintain a valuation allowance against the Company's net deferred tax assets. During fiscal 2013, the Company recorded a net increase in its federal valuation allowance of $13.0 million.

At December 29, 2013, the Company had federal tax loss carryforwards of $325.4 million and various state tax loss carryforwards of $237.4 million including net operating losses resulting from stock options of $14.4 million for federal and state, which if recognized would result in additional paid-in-capital. The federal tax loss carryforwards will begin to expire in 2018 and state tax loss carryforwards will begin to expire in 2014 in certain states.
Federal and state income tax laws impose restrictions on the utilization of net operating loss (“NOL”) and tax credit carryforwards in the event that an “ownership change” occurs for tax purposes, as defined by Section 382 of the Internal Revenue Code of 1986, as amended (“Section 382”). In general, an ownership change occurs when shareholders owning 5% or more of a “loss corporation” (a corporation entitled to use NOL or other loss carryovers) have increased their ownership of stock in such corporation by more than 50 percentage points during any 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. This base limitation is subject to adjustments, including an increase for built-in gains recognized in the five year period after the ownership change. In March 2010, an “ownership change” occurred that will limit the utilization of NOL carryforwards. In July 2011, another “ownership change” occurred. The March 2010 ownership change limitation is more restrictive. In prior years the company acquired corporations with NOL carryforwards at the date of acquisition (Acquired NOLs). The Acquired NOLs are subject to separate limitations that may further restrict the use of Acquired NOLs. As a result, the Company's federal annual utilization of

NOL carryforwards will be limited to at least $27 million a year for the five years succeeding the March 2010 ownership change and at least $11.6 million for each year thereafter subject to separate limitations for Acquired NOL. If the entire limitation amount is not utilized in a year, the excess can be carried forward and utilized in future years. For the year ended December 29, 2013, there was no impact of such limitations on the income tax provision since the amount of taxable income did not exceed the annual limitation amount. In addition, future equity offerings or acquisitions that have equity as a component of the purchase price could also cause in an "ownership change." If and when any other "ownership change"

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occurs, utilization of the NOL or other tax attributes may be further limited. As discussed elsewhere, deferred tax assets relating to the NOL and credit carryforwards are offset by a full valuation allowance. In addition, utilization of state tax loss carryforwards is dependent upon sufficient taxable income apportioned to the states.
The Company has not provided deferred U.S. income taxes or foreign withholding taxes of approximately $15.7 million on temporary differences relating to the outside basis in its investment in foreign subsidiaries which are essentially permanent in duration. It is the Company's intention to permanently reinvest undistributed earnings of its foreign subsidiaries. As of December 29, 2013 the Company has $16.0 million of cash and cash equivalents available for distribution.

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

The following table summarizes the activity related to the Company's unrecognized tax benefits (in millions):

Balance as of December 26, 2010	$12.4	
Increases related to prior periods (acquired entities)	0.5	
Increases related to current year tax positions	0.2	
Expiration of applicable statutes of limitations	(0.6	)
Settlements with taxing authorities	(2.4	)
Balance as of December 25, 2011	10.1	
Increases related to prior periods (acquired entities)	3.7	
Increases related to current year tax positions	—	
Expiration of applicable statutes of limitations	(0.1	)
Settlements with taxing authorities	(0.3	)
Balance as of December 30, 2012	13.4	
Increases related to prior periods (acquired entities)	3.3	
Increases related to current year tax positions	1.7	
Expiration of applicable statutes of limitations	(2.6	)
Settlements with taxing authorities	—	
Balance as of December 29, 2013	$15.8	

Included in the balance of unrecognized tax benefits at December 29, 2013, are $15.8 million of tax benefits that, if recognized, would affect the effective tax rate. Included in this amount is $14.5 million that would become a deferred tax asset if the tax benefit were recognized. As such, this benefit may be impacted by a corresponding valuation allowance depending upon the Company's consolidated financial position at the time the benefits are recognized.

The Company recognizes interest and penalties related to unrecognized tax benefits in its provision for income taxes. For the years ended December 25, 2011, December 30, 2012 and December 29, 2013, the Company recorded $0.3 million, $0.4 million and $0.2 million, respectively, in interest or penalties. These amounts are netted by a benefit for interest and penalties related to the reversal of prior positions as noted above of $0.4 million, $0.1 million, and $0.2 million for the years ended December 25, 2011, December 30, 2012, and December 29, 2013, respectively. As of December 25, 2011, December 30, 2012, and December 29, 2013, the Company had recorded total interest and penalties of $0.4 million, $0.7 million, and $0.7 million, respectively.

The Company believes that that no material amount of the liabilities for uncertain tax positions will expire within 12 months of December 29, 2013.

Note 9. Discontinued Operations

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In June of 2012, consistent with the Company's plans to complete its assessment and evaluation of the non-core businesses acquired in the Integral acquisition, the Company committed to a plan to sell certain lines of business associated with antennas, satellite-cased products and fly-away terminals. These operations were previously reported in the KGS segment, and in accordance with Topic 205, these businesses have been classified as held for sale and reported in discontinued operations in the accompanying consolidated financial statements. In the second quarter of 2012, the Company recorded a $1.5 million impairment charge associated with the portion of goodwill that was allocated to the discontinued businesses based on management's estimate of the fair value of the discontinued businesses. The Company sold its domestic operations to two buyers for approximately $0.8 million in cash consideration and the assumption of certain liabilities. The Company received $0.3 million in cash in 2012 from the first buyer and $0.5 million in cash in April 2013 from the second buyer. The Company recorded a $1.2 million impairment charge in the first quarter of 2013 related to its revised estimate of the fair value of these operations.

The following table presents the results of discontinued operations including gain and loss on disposals which is included in loss before taxes (in millions):

	Year ended December 25, 2011	Year ended December 30, 2012	Year ended December 29, 2013
Revenue	$9.2	$18.5	$3.7
Loss before taxes	(1.3)	(1.8)	(5.3)
Benefit for income taxes	(0.6)	(0.3)	—
Net loss	$(0.7)	$(1.5)	$(5.3)

The benefit for income taxes for the year ended December 25, 2011 and December 30, 2012 was primarily due to the expiration of the statute of limitations for certain foreign tax contingencies related to the Company’s discontinued wireless services business.

The following is a summary of the assets and liabilities of discontinued operations, which are in other current assets, other non-current assets, other current liabilities and other long-term liabilities in the accompanying Consolidated Balance Sheets as of December 30, 2012 and December 29, 2013 (in millions):

	December 30, 2012	December 29, 2013
Accounts receivable, net	$3.4	$—
Inventoried costs	3.0	—
Other current assets	0.2	—
Current assets of discontinued operations	$6.6	$—
Property and equipment, net	$0.4	$—
Other assets	0.4	—
Long-term assets of discontinued operations	$0.8	$—
Accrued expenses and accounts payable	$4.4	$1.1
Billings in excess of costs and earnings on uncompleted contracts	0.1	—
Other current liabilities	0.4	1.4
Current liabilities of discontinued operations	$4.9	$2.5
Other long-term liabilities	$0.3	$0.2
Long-term liabilities of discontinued operations	$0.3	$0.2

Note 10. Fair Value Measurement

The Company adopted Topic 820 with the exception of the application of the statement to non-recurring nonfinancial assets and nonfinancial liabilities. Non-recurring nonfinancial assets and nonfinancial liabilities for which it has not applied the provisions of Topic 820 include those measured at fair value in goodwill impairment testing, indefinite lived intangible assets measured at fair value for impairment testing, asset retirement obligations initially measured at fair value, and those assets and liabilities initially measured at fair value in a business combination.

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Topic 820 establishes a valuation hierarchy for disclosure of the inputs to valuation used to measure fair value. This hierarchy prioritizes the inputs into three broad levels as follows. Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities. Level 2 inputs are quoted prices for similar assets and liabilities in active markets or inputs that are observable for the asset or liability, either directly or indirectly through market corroboration, for substantially the full term of the financial instrument. Level 3 inputs are unobservable inputs based on the Company's own assumptions used to measure assets and liabilities at fair value. A financial asset or liability's classification within the hierarchy is determined based on the lowest level input that is significant to the fair value measurement.

Note 11. Stockholders' Equity

(a) Common Stock

On May 14, 2012, the Company sold 20.0 million shares of its common stock at a purchase price of $5.00 per share in an underwritten public offering. The Company received gross proceeds of $100.0 million. After deducting underwriting and other offering expenses, the Company received approximately $97.0 million in net proceeds. The Company used the net proceeds from this offering to fund a portion of the cash consideration paid to the stockholders of CEI in connection with the Company's acquisition thereof on July 2, 2012.

On December 1, 2011, the Company repurchased in the open market from an institutional investor 2.0 million shares of its common stock for $5.45 per share, in a block transaction in compliance with legal requirements.

On July 27, 2011, in connection with the acquisition of Integral, the Company issued approximately 10.4 million shares of its common stock to shareholders of Integral. See Note 3 for a complete description of this transaction.

On February 11, 2011, the Company sold approximately 4.9 million shares of its common stock at a purchase price of $13.25 per share in an underwritten public offering. The Company received gross proceeds of approximately $64.8 million. After deducting underwriting and other offering expenses, the Company received approximately $61.1 million in net proceeds.

(b) Preferred Stock

On March 8, 2011, all of the 10,000 shares of the previously issued and outstanding shares of Series B Convertible Preferred Stock ("Preferred Stock") were redeemed for 100,000 shares of common stock. Prior to the redemption, the Preferred Stock had a total liquidation preference of $5.0 million. In accordance with Topic 260, the Preferred Stock was considered a participating security for purposes of computing basic earnings per share prior to redemption.

(c) Stock Option Plans and Restricted Stock Unit Plans

The Company's board of directors ("Board") may grant equity-based awards to selected employees, directors and consultants of the Company pursuant to its existing equity incentive plans. In February 2005, the Board approved the 2005 Equity Incentive Plan ("2005 Plan"). The 2005 Plan was subsequently approved by a majority of the Company's stockholders on May 18, 2005. In March 10, 2011, the Board approved the 2011 Equity Incentive Plan ("2011 Plan"). The 2011 Plan was subsequently approved by a majority of the Company's stockholders on May 27, 2011. Each of the 2005 Plan and the 2011 Plan permits the Board to issue a wide-variety of awards, including restricted stock units, restricted stock, stock appreciation rights, stock options and deferred stock units. If any shares covered by an award under the 2005 Plan or 2011 Plan are not purchased or are forfeited, or if an award otherwise is terminated, canceled or retired, such shares are again made available for awards under the 2005 Plan and 2011 Plan. As of December 29,

2013, there are approximately 362,000 and 1.0 million shares reserved for issuance for future grant under the 2005 Plan and 2011 Plan, respectively. The Board may amend or terminate the 2005 Plan or 2011 Plan at any time. Certain amendments, including an increase in the share reserve, require stockholder approval. Generally, options and restricted stock units outstanding vest over periods not exceeding ten years. When the Company grants stock options, they are granted with a per share exercise price not less than the fair market value of the Company's common stock on the date of grant, and generally would be exercisable for up to ten years from the grant date.

Integral Stock Option Plans. All outstanding options to purchase shares of Integral common stock that were not canceled and exchanged for a cash payment upon completion of the Integral merger, were assumed by the Company and converted into options to purchase shares of the Company's common stock (with the number of shares subject to each such option and the exercise price applicable to each such option adjusted based on the applicable exchange ratio) (the “Assumed Options”). The Company assumed each such stock option in accordance with the terms and conditions of the applicable Integral option plan and stock option agreement, subject to the adjustments described in the preceding sentence. On February

20, 2012, the Board confirmed (i) the assumption of Integral's 2008 Stock Incentive Plan (the “2008 Plan”), pursuant to NASDAQ Rule 5635, which provides that shares available under certain plans acquired in mergers and other acquisitions may be used for certain post-transaction grants without further stockholder approval and (ii) an amendment to the 2008 Plan, in order to permit the future grant of awards, including restricted stock unit awards, by the Company pursuant to the plan. The 2008 Plan was approved by Integral's Board of directors in December 2007 and by Integral's stockholders in February 2008. The terms and conditions of specific awards are set at the discretion of the Board. As of December 29, 2013, there are approximately 1.3 million shares of the Company's common stock available for issuance under the 2008 Plan. The shares of common stock available for issuance under the 2008 Plan may be used to grant awards, including stock options, stock appreciation rights, restricted stock and restricted stock units, to any employee, director or consultant who was not an employee, director or consultant of the Company prior to the consummation of the Integral merger. The Board may amend or terminate the 2008 Plan at any time. However, certain amendments, including an increase in the share reserve, would require stockholder approval.

Herley Stock Option Plans. All outstanding options to purchase shares of Herley common stock that were not canceled and exchanged for a cash payment upon completion of the Herley merger, were assumed by the Company and converted into options to purchase shares of the Company's common stock (with the number of shares subject to each such option and the exercise price applicable to each such option adjusted based on the applicable exchange ratio). The Company assumed each such stock option in accordance with the terms and conditions of the applicable Herley option plan and stock option agreement, subject to the adjustments described in the preceding sentence. On December 30, 2012, the Board confirmed (i) the assumption of Herley's 2010 Stock Plan (the “2010 Plan”), pursuant to NASDAQ Rule 5635, and (ii) an amendment to the 2010 Plan, in order to permit the future grant of awards, including restricted stock unit awards, by the Company pursuant to the plan. The 2010 Plan was approved by Herley's Board of Directors in January 2010 and by Herley's stockholders in March 2010. The terms and conditions of specific awards are set at the discretion of the Board. As of December 29, 2013, there are approximately 365,000 shares of the Company's common stock available for issuance under the 2010 Plan. These shares are available to grant awards, including stock options, shares of common stock and restricted stock units, to any employee, director or consultant who was not an employee, director or consultant of the Company prior to the consummation of the Herley merger. The Board of the Company may amend or terminate the 2010 Plan at any time. However, certain amendments, including an increase in the share reserve, would require stockholder approval.

Henry Bros. Electronics Stock Option Plans. HBE's stock option and stock incentive plans acquired in connection with the Company's acquisition of HBE were terminated on December 15, 2010, and no further grants may be made under these plans after such date. Award grants that were outstanding under these plans on December 15, 2010 will continue to be governed by their existing terms and may be exercised for shares of the Company's common stock at any time prior to the expiration of the option term or any earlier termination of those options in connection with the option holder's cessation of service with the Company. Stock options granted under these plans were incentive stock options, may generally be exercised from one to ten years after the date of grant and generally vest ratably over three to five years. Certain of these options had change in control provisions that accelerated the vesting of the options.

Digital Fusion Inc. Stock Option and Stock Incentive Plans. DFI's stock option and stock incentive plans acquired in connection with the Company's acquisition of DFI were terminated on December 24, 2008, and no further grants may be made under these plans after such date. Award grants that were outstanding under these plans on December 24, 2008 will continue to be governed by their existing terms and may be exercised for shares of the Company's common stock at any time prior to the expiration of the ten-year option term or any earlier termination of those options in connection with the option holder's cessation of service with the Company. Stock options granted under these plans included incentive stock options or non-statutory stock options. All non-statutory options vest upon change in control and were 100% vested on December 24, 2008. With respect to incentive stock options, the qualified stock option plans provide that the exercise price of each such option must be at least equal to 100% of the fair market value of its common stock on the date of grant. Stock options granted under these plans may generally be exercised from one to

ten years after the date of grant. Certain of these options had change in control provisions that extended the exercise period for grants for two years from the transaction closing date. Awards granted under these plans generally vest equally over three years; however, in connection with the Company's acquisition of DFI the plans were amended to include immediate vesting of all unvested grants upon any future change in control of the Company. DFI also had certain options granted outside of its qualified stock option plans. These non-qualified “out of plan” stock options expire 10 years from grant date.

RSU Agreements. On January 10, 2007, the Compensation Committee of the Board approved a form of Restricted Stock Unit Agreement (an RSU Agreement) to govern the issuance of restricted stock units (“RSUs”) to executive officers under the Company's 2005 Plan. On November 14, 2011, the Compensation Committee of the Board approved a form of RSU Agreement to govern the issuance of RSUs to executive officers under the Company's 2011 Plan. Each RSU represents the right to receive a share of common stock (a “Share”) on the vesting date. Unless and until the RSUs vest, the Employee will have no

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right to receive Shares under such RSUs. Prior to actual distribution of Shares pursuant to any vested RSUs, such RSUs will represent an unsecured obligation of the Company, payable (if at all) only from the general assets of the Company. The RSUs that may be awarded to executive officers under an RSU Agreement will vest according to vesting schedules specified in the notice of grant accompanying each grant. The Company recognizes compensation expense on a straight-line basis over the vesting periods based on the market price of the Company's stock on the grant date. The awards granted in 2011, 2012, and 2013 had vesting periods ranging from 2 to 10 years; 1 to 10 years, and 1 to 10 years, respectively. Some of the grants for these years have accelerated vesting occurring upon change of control or termination. Upon exercise of the RSU, the Company issues new shares of common stock.

The Company records compensation expense for employee stock options based on the estimated fair value of the options on the date of grant using the Black-Scholes option-pricing model or a trinomial lattice options pricing model with the weighted average assumptions (annualized percentages) included in the following table. Awards with graded vesting are recognized using the straight-line method with the following assumptions:

	2011	2012	2013
Stock Options			
Expected life (1)	2.2	10.0	6.25 - 10.0
Risk-free interest rate(2)	0.1% - 3.4%	1.6% - 2.3%	1.1% - 2.9%
Volatility(3)	29.3% - 65.3%	59.0% - 59.7%	56.8% - 61.2%
Forfeiture rate(4)	16.3%	16.3%	10%
Dividend yield(5)	—%	—%	—%

(1) In 2011 and 2012, no unvested options were granted and the expected life was equal to the life of the option.
(2) The risk-free interest rate is based on U.S. Treasury yields in effect at the time of grant with a term equal to the expected term of the options.
(3) In 2011, 2012, and 2013, the Company estimated implied volatility based upon trailing volatility.
(4) Forfeitures are estimated at the time of grant based upon historical information. Forfeitures will be revised, if necessary, in subsequent periods if actual forfeitures differ from estimates.
(5) The Company has no history or expectation of paying dividends on its common stock.

A summary of the status of the Company's stock option plan as of December 29, 2013 and changes in options outstanding under the plan for the year ended December 29, 2013 is as follows:

	Number of Shares Under Option	Weighted-Average Exercise Price per Share	Weighted-Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value
	(000's)			(000's)
Options outstanding at December 30, 2012	1,133	$ 27.66	2.8	$80.0
Granted	1,012	$ 5.03	—	—
Exercised	(7)	$ 5.05	—	—
Forfeited or expired	(417)	$ 32.95	—	—
Options outstanding at December 29, 2013	1,721	$ 13.16	5.8	$2,179.0
Options exercisable at December 29, 2013	821	$ 22.09	2.4	$249.0

As of December 29, 2013, there was $2.1 million of total unrecognized stock-based compensation expense related to nonvested options which is expected to be recognized over a remaining weighted-average vesting period of 4.2 years.

Upon exercise of an option, the Company issues new shares of common stock.

During the years ended December 25, 2011, December 30, 2012, and December 29, 2013 the following values relate to the grants and exercises under the Company's option plans:

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	2011	2012	2013
Weighted average grant date fair value of options granted	$2.38	$3.56	$2.86
Total intrinsic value of options exercised (in thousands)	$1,832	$—	$—

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

	Restricted Stock Units (000's)	Weighted-Average Grant Date Fair Value
Nonvested balance at December 30, 2012	3,670	$ 7.53
Grants	53	$ 12.69
Vested	(132)	$ 12.89
Forfeitures	(243)	$ 9.34
Vested but not released	(3)	$ 12.39
Nonvested balance at December 29, 2013	3,345	$ 7.26

As of December 29, 2013, there was $15.8 million of total unrecognized stock-based compensation expense related to nonvested restricted stock units which is expected to be recognized over a remaining weighted-average vesting period of 3.2 years. The fair value of RSU awards that vested in 2011, 2012, and 2013 was $0.8 million, $1.9 million, and $1.7 million, respectively.

(d) Employee Stock Purchase Plan

In August 1999, the Board approved the 1999 Employee Stock Purchase Plan (“Purchase Plan”). A total of 2,689 thousand shares of Common Stock have been authorized for issuance under the Purchase Plan. The Purchase Plan qualifies as an employee stock purchase plan within the meaning of Section 423 of the Internal Revenue Service Code. Unless otherwise determined by the Compensation Committee of the Board, all employees are eligible to participate in the Purchase Plan so long as they are employed by the Company (or a subsidiary designated by the Board) for at least 20 hours per week and were customarily employed by the Company (or a subsidiary designated by the Board) for at least 5 months per calendar year.

Employees who actively participate in the Purchase Plan are eligible to have up to 15% of their earnings for each purchase period withheld pursuant to the Purchase Plan. The amount that is withheld is used at various purchase dates within the offering period to purchase shares of Common Stock. The price paid for Common Stock at each such purchase date is equal to the lower of 85% of the fair market value of the Common Stock at the commencement date of that offering period or 85% of the fair market value of the Common Stock on the relevant purchase date. Employees are also able to end their participation in the offering at any time during the offering period, and participation ends automatically upon termination of employment. From the Purchase Plan's inception through December 29, 2013, the cumulative number of shares of Common Stock that have been issued under the Purchase Plan is 1,784 thousand and approximately 1,924 thousand shares are available for future issuance. During fiscal 2012, approximately 781 thousand shares were issued under the plan at an average price of $5.19.

The fair value of Kratos' Purchase Plan shares for 2013 was estimated using the Black-Scholes option pricing model. The assumptions and resulting fair values of options granted for 2012 and 2013 were as follows:

	Offering Periods January 1 to December 31, 2011	Offering Periods January 1 to December 31, 2012	Offering Periods January 1 to December 31 2013
Expected term (in years)(1)	0.5	0.5	0.5
Risk-free interest rate(2)	0.10% - 0.19%	0.06% - 0.16%	0.10% - 0.11%
Expected volatility(3)	28.5% - 43.6%	49.70% - 65.73%	36.95% - 43.70%
Expected dividend yield(4)	0%	0%	0%
Weighted average grant-date fair value per share	$3.05	$1.93	$1.50

(1) The expected term is equivalent to the offering period.
(2) The risk-free interest rate is based on U.S. Treasury yields in effect at the time of grant with a term equal to the expected term.
(3) The Company estimated implied volatility based upon trailing volatility.
(4) The Company has no history or expectation of paying dividends on its common stock.

As of December 29, 2013, there was no material unrecognized compensation expense related to the Employee Stock Purchase Plan.

(e) Stockholder Rights Agreement

On December 16, 2004, the Company entered into a Stockholder Rights Agreement (the "Rights Agreement"). Under the terms of the Rights Agreement, initially, the rights ("Rights") will attach to all certificates representing shares of outstanding Company common stock and no separate rights certificates will be distributed. Subject to the provisions of the Rights Agreement, the Rights will separate from the Company common stock and the distribution date will occur upon the earlier of (i) ten business days following a public announcement that a person or group of affiliated or associated persons has acquired or obtained the right to acquire beneficial ownership of 15% or more of the then-outstanding common stock (an Acquiring Person), or (ii) ten business days (or such later date as may be determined by action of the Board) prior to such time as any person becomes an Acquiring Person following the commencement of a tender offer or exchange offer that would result in a person or group becoming an Acquiring Person. An Acquiring Person does not include certain persons specified in the Rights Agreement. The Rights Agreement was amended on May 14, 2012 to, among other things, redefine the term Acquiring Person to exclude a newly defined term Exempt Person from the definition of Acquiring Person. The term Exempt Person is defined to include: (A) the Company; (B) any subsidiary of the Company; (C) any employee benefit plan maintained by the Company or any of its subsidiaries; (D) any trustee or fiduciary with respect to such employee benefit plan acting in such capacity or trustee or fiduciary holding shares of Company Common Stock for the purpose of funding any such plan or employee benefits; (E) Oak Investment Partners IX, L.P., Oak IX Affiliates Fund, L.P., Oak IX Affiliates Fund-A, L.P., Oak X Affiliates Fund, L.P., Oak Investment Partners X, L.P., Oak Investment Partners XIII, L.P., or their Affiliates and Associates (collectively, the "Oak Parties) as long as the Oak Parties, individually or in the aggregate, are not the beneficial owner of more than 25% of the outstanding shares of Company stock (other than pursuant to a transaction authorized in writing in advance by the Board of Directors) and certain specified criteria are met.

On December 16, 2004, the Board authorized and declared a dividend of one right (a Right) to purchase one one-hundredth of a share of the Company's Series C Preferred Stock (Series C Preferred) for each outstanding share of common stock, par value $0.001, to stockholders of record as of the close of business December 27, 2004. Each Right entitles the registered holder, subject to the terms of the Rights Agreement, to purchase from the Company one one-hundredth of a share of Series C Preferred Stock at a purchase price of $54.00, subject to adjustment.

The Rights are not exercisable until the distribution date and will expire at the close of business on the tenth anniversary of the Rights Agreement unless earlier redeemed or exchanged by the Company.

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Note 12. Retirement Plans

The Company provides eligible employees the opportunity to participate in defined-contribution savings plans (commonly known as 401(k) plans), which permit contributions on a before-tax basis. Generally, salaried employees and certain hourly employees are eligible to participate in the plans. Under most plans, the employee may contribute to various investment alternatives. In certain plans, the Company matches a portion of the employees' contributions. The Company's contributions to these defined-contribution plans totaled $7.3 million in 2011, $5.1 million in 2012 and $6.0 million in 2013.

Note 13. Significant Customers

Revenue from the U.S. Government (which includes Foreign Military Sales) includes revenue from contracts for which Kratos is the prime contractor as well as those for which the Company is a subcontractor and the ultimate customer is the U.S. Government. The KGS segment has substantial revenue from the U.S. Government. Sales to the U.S. Government amounted to approximately $534.5 million, $627.8 million, and $606.7 million or 75%, 65%, and 64%, of total revenue for the years ended December 25, 2011, December 30, 2012, and December 29, 2013, respectively.

Note 14. Segment Information

The Company operates in two reportable business segments: Kratos Government Solutions and Public Safety & Security. The KGS segment provides products, solutions and services primarily for mission critical national security priorities. KGS customers primarily include national security related agencies, the DoD, intelligence agencies and classified agencies. The PSS segment provides independent integrated solutions for advanced homeland security, public safety, critical infrastructure, and security and surveillance systems for government and commercial applications. PSS customers are in the critical infrastructure, power generation, power transport, nuclear energy, financial, IT, healthcare, education, transportation and petro-chemical industries, as well as certain government and military customers.

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

Revenues, operating income (loss) and assets disclosed below provided by the Company's reportable segments for the years ended December 25, 2011, December 30, 2012, and December 29, 2013, are as follows (in millions):

	2011	2012	2013
Revenues:			
Kratos Government Solutions			
Service revenues	$238.8	$264.0	$233.9
Product sales	362.9	519.2	507.0
Total Kratos Government Solutions	601.7	783.2	740.9
Public Safety & Security			
Service revenues	112.2	186.0	209.7
Product sales	—	—	—
Total Public Safety & Security	112.2	186.0	209.7
Total revenues	$713.9	$969.2	$950.6
Depreciation and amortization:			
Kratos Government Solutions	$45.7	$54.5	$49.9
Public Safety & Security	2.3	3.5	3.5
Total depreciation and amortization	$48.0	$58.0	$53.4
Operating income (loss) from continuing operations:			
Kratos Government Solutions	$35.4	$(41.5)	$26.4
Public Safety & Security	9.9	(2.5)	8.3
Corporate activities	(15.8)	(5.7)	(2.9)
Total operating income (loss) from continuing operations	$29.5	$(49.7)	$31.8

Revenues from foreign customers were approximately $54.3 million or 8%, $116.2 million or 12% and $100.9 million or 11% of total revenue for the years ended December 25, 2011, December 30, 2012, and December 29, 2013, respectively.

In 2012, the Company recorded an impairment of goodwill and intangible assets of $83.7 million related to the KGS reportable segment and an impairment of intangible assets of $12.9 million related to the PSS reportable segment. See Note 2.

In 2011 the Company had corporate merger and acquisition expenses of approximately $12.5 million, and in 2012 had a benefit from merger related items of $2.7 million due to a reduction in contingent consideration, settlement of a dispute on fees, and a change in estimate of indemnity obligations related to former directors and officers of Integral. A corporate benefit of $2.0 million for the year ended December 29, 2013, was due to the reduction in a $3.1 million liability as a result of the final settlement of the indemnity obligations related to former directors and officers of Integral on July 1, 2013, partially offset by other merger expenses and legal fees related to prior acquisitions.

Reportable segment assets are as follows (in millions):

	December 30, 2012	December 29, 2013
Assets:		
Kratos Government Solutions	$ 1,103.9	$ 1,025.6
Public Safety & Security	106.8	122.6
Discontinued operations	7.5	—
Corporate activities	65.7	68.4

Total assets	$ 1,283.9	$ 1,216.6

The increases in the assets in the KGS and PSS segments are primarily attributable to the acquisitions of CEI on July 2, 2012 and the Critical Infrastructure Business on December 30, 2011. Assets of foreign subsidiaries were $90.0 million and $95.9 million as of December 30, 2012 and December 29, 2013, respectively.

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Note 15. Commitments and Contingencies

In addition to commitments and obligations in the ordinary course of business, the Company is subject to various claims, pending and potential legal actions for damages, investigations relating to governmental laws and regulations and other matters arising out of the normal conduct of the Company's business. The Company assesses contingencies to determine the degree of probability and range of possible loss for potential accrual in its Consolidated Financial Statements. An estimated loss contingency is accrued in its Consolidated Financial Statements if it is probable that a liability has been incurred and the amount of the loss can be reasonably estimated. Because litigation is inherently unpredictable and unfavorable resolutions could occur, assessing litigation contingencies is highly subjective and requires judgments about future events. When evaluating contingencies, the Company may be unable to provide a meaningful estimate due to a number of factors, including but not limited to the procedural status of the matter in question, the presence of complex or novel legal theories, and the ongoing discovery and development of information important to the matters. In addition, damage amounts claimed in litigation against it may be unsupported, exaggerated or unrelated to possible outcomes, and as such are not meaningful indicators of its potential liability. The Company regularly reviews contingencies to determine the adequacy of its accruals and related disclosures. The amount of ultimate loss may differ from these estimates. It is possible that cash flows or results of operations could be materially affected in any particular period by the unfavorable resolution of one or more of these contingencies. Whether any losses finally determined in any claim, action, investigation or proceeding could reasonably have a material effect on the Company's business, financial condition, results of operations or cash flows will depend on a number of variables, including: the timing and amount of such losses; the structure and type of any remedies; the monetary significance of any such losses, damages or remedies may have on the Consolidated Financial Statements; and the unique facts and circumstances of the particular matter that may give rise to additional factors.

(a) Legal and Regulatory Matters.

Integral Indemnification Obligation. Integral, which was acquired on July 27, 2011, was previously the subject of a SEC investigation. On July 30, 2009, the SEC and Integral each announced that an administrative settlement had been reached concluding the SEC's investigation. In conjunction with its announcement of the administrative settlement, the SEC disclosed that it was instituting separate civil actions against three former officers of Integral, Steven R. Chamberlain (now deceased), Elaine M. Brown and Gary A. Prince in a case filed July 30, 2009 captioned United States Securities and Exchange Commission v. Steven R. Chamberlain, Elaine M. Brown, and Gary A. Prince, Case No. 09-CV-01423, in the United States District Court for the District of Columbia. The SEC's complaint alleges that from 1999 through August 2006, Chamberlain, Brown and Prince made materially false and misleading statements and omitted material information in various filings with the SEC by failing to disclose the role of Prince, who had been convicted of engaging in securities fraud while at another company, at Integral and his legal background in its filings. The SEC sought permanent injunctions against each defendant, as well as court orders imposing officer and director bars and civil penalties. Integral had indemnification obligations to these individuals, as well as to other former directors and officers of Integral who might incur indemnifiable costs in connection with these actions, pursuant to the terms of separate indemnification agreements entered into with each of them effective as of December 4, 2002. As a result of the acquisition of Integral, the Company assumed these indemnification obligations. The indemnification agreements each provide, subject to certain terms and conditions, that the Company shall indemnify the individual to the fullest extent permissible by Maryland law against judgments, penalties, fines, settlements and reasonable expenses actually incurred in the event that the individual is made a party to a legal proceeding by reason of his or her present or prior service as an officer or employee of Integral, and shall also advance reasonable litigation expenses actually incurred subject to, among other conditions, receipt of a written undertaking to repay any costs or expenses advanced if it shall ultimately be determined that the individual has not met the standard of conduct required for indemnification under Maryland law. Certain costs and expenses were previously covered under Integral's applicable directors and officers liability insurance policy. The policy limits were exhausted in December 2011, and the Company thereafter advanced payment of indemnifiable costs pursuant to the indemnification agreements. On November 26, 2012, the SEC announced that it had finalized a settlement with Elaine

M. Brown, resulting in a final judgment that resolved the SEC's matter against Brown. The SEC's case against Gary A. Prince proceeded to a bench trial in December 2012, which trial concluded in January 2013. On May 2, 2013, the court issued a memorandum opinion and entered an order granting judgment in favor of the SEC on one count of its complaint. The court found that in 1997, an accounting bar order had been issued against Mr. Prince because of his conduct at a different company, and that Mr. Prince violated the bar order between 1998 and 2006. The court issued an injunction permanently restraining and enjoining Mr. Prince from violating the accounting bar order. The court entered judgment in favor of Mr. Prince on all other counts of the SEC's complaint. No relief was sought or entered against Integral. The deadline for appeals expired on July 1, 2013. Neither party appealed, so the trial court's judgment is final. This matter is now concluded.

U.S. Government Cost Claims. The Company's contracts with the Department of Defense are subject to audit by the Defense Contract Audit Agency (“DCAA”). As a result of these audits, from time to time, the Company is advised of claims concerning potential disallowed, overstated or disputed costs. For example, during the course of its current audits, the DCAA

is closely examining and questioning certain of its established and disclosed practices that it had previously audited and accepted. In addition, based on a DCAA audit, the U.S. Department of Justice is currently investigating whether one of our subsidiaries violated the federal False Claims Act by overstating its labor and material costs in a contract with the Department of Defense prior to the Company's acquisition of the subsidiary. Under the False Claims Act, the Department of Justice can seek civil penalties plus treble damages. The Company intends to defend itself in these matters and to work to resolve or settle any disputed contract costs. When appropriate, the Company records accruals to reflect its expected exposure to the matters raised by the U.S. Government, and it reviews such accruals on a quarterly basis for sufficiency based on the most recent information available. Based on its assessment, it has accrued an amount in its financial statements for contingent liabilities associated with these matters that it considers to be immaterial to its overall financial position. The matter that is currently being investigated was identified during the acquisition process and was taken into consideration in the purchase price allocation of this subsidiary. Contract disputes with the U.S. government, however, are inherently unpredictable, and unfavorable resolutions could occur. As a result, assessing contingencies is highly subjective and requires judgment about future events. The amount of ultimate loss may exceed the Company's current accruals, and it is possible that its cash flows or results of operations could be materially affected in any particular period by the unfavorable resolution of one or more of these contingencies.

Other Litigation Matters. The Company is subject to normal and routine litigation arising from the ordinary course and conduct of business, and, at times, as a result of acquisitions and dispositions. Such disputes include, for example, commercial, employment, intellectual property, environmental and securities matters. The aggregate amounts accrued related to these matters are not material to the total liabilities of the Company. We intend to defend ourselves in any such matters and do not currently believe that the outcome of any such matters will have a material adverse impact on our financial condition, results of operations or cash flows.

(b) Warranty

Certain of the Company’s products, product finishes, and services are covered by a warranty to be free from defects in material and workmanship for periods ranging from one to ten years. Optional extended warranty contracts can also be purchased with the revenue deferred and amortized over the extended warranty period. The Company accrues a warranty liability for estimated costs to provide products, parts or services to repair or replace products in satisfaction of warranty obligations. Warranty revenues related to extended warranty contracts are amortized to income, over the life of the contract, using the straight-line method. Costs under extended warranty contracts are expensed as incurred.

The Company’s estimate of costs to service its warranty obligations is based upon historical experience and expectations of future conditions. To the extent that the Company experiences any changes in warranty claim activity or costs associated with servicing those claims, its warranty liability is adjusted accordingly.

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

	Year Ended	
	December 30, 2012	December 29, 2013
Balance, at beginning of the period	$3.8	$5.2
Costs accrued and revenues deferred	1.8	1.2
Warranty liabilities assumed from acquisitions	0.4	—
Adjustments to preexisting warranties	(0.7)	(0.9)
Settlements made (in cash or kind) and revenues recognized	(0.1)	(0.1)

Balance, at end of period	5.2	5.4
Less: Non-Current portion	0.3	0.3
Current warranty liability	$4.9	$5.1

(c) Self-Insured Health and Workers' Compensation Plans

The Company has health plans which are self-insured and also has liabilities related to its self-insured worker's compensation plans for its discontinued wireless business. The liabilities related to the health plans are a component of total accrued expenses and the liabilities related to the workers' compensation plans are a component of current liabilities of discontinued operations in the Consolidated Balance Sheets. Management determines the adequacy of these accruals based on

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an evaluation of the Company's historical experience and trends related to both medical and workers' compensation claims and payments, information provided to the Company by the Company's insurance broker, industry experience and the average lag period in which claims are paid. If such information indicates that the Company's accruals require adjustment, the Company will, correspondingly, revise the assumptions utilized in the Company's methodologies and reduce or provide for additional accruals as deemed appropriate.

As of December 30, 2012, and December 29, 2013, the accrual for the Company's partial self-insurance programs approximated $0.1 million and $0.2 million for its health insurance and $0.2 million and $0.2 million for its workers' compensation insurance, respectively. The Company also carries stop-loss insurance that provides coverage limiting the Company's total exposure related to each medical and workers' compensation claim incurred, as defined in the applicable insurance policies. The medical annual claim limits are $50,000 - $85,000 and the workers' compensation claim limits are $250,000 - $350,000 depending upon the plan year. In 2011, 2012, and 2013, no claims exceeded the limits for workers' compensation. In 2011, 2012 and 2013, the Company had eight, no, and no claims, respectively, which exceeded the limits for medical insurance.

Note 16. Quarterly Financial Data (Unaudited)

The following financial information reflects all normal and recurring adjustments that are, in the opinion of management, necessary for a fair statement of the results of the interim periods. Summarized quarterly data for the years ended December 30, 2012 and December 29, 2013, is as follows (in millions, except per share data):

Quarterly Results in 2012

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Fiscal year 2012				
Revenues	$209.5	$219.8	$276.3	$263.6
Gross profit	$57.4	$57.7	$74.1	$68.0
Operating income from continuing operations	$9.1	$7.4	$14.1	$(80.3)
Provision (benefit) for income taxes	$(4.1)	$6.6	$1.3	$(5.4)
Net loss	$(3.0)	$(17.2)	$(4.2)	$(90.0)
Net loss per common share:				
Basic and diluted	$(0.09)	$(0.41)	$(0.07)	$(1.59)

The quarterly increases in revenues and expenses in the third and fourth quarter are a result of the Company's acquisition of CEI. See Note 3.

In the fourth quarter the Company incurred an impairment of goodwill and intangible assets of $96.6 million. See Note 2.

During the first, second, and third quarters, the Company incurred $0.9 million, $1.5 million, and $0.3 million, respectively, of expenses related to the Company's acquisitions during those quarters and during the fourth quarter the Company had a benefit of $2.7 million related to acquisition items. Also included in each of the first, second, third and fourth quarter is amortization of purchased intangibles of $10.5 million, $8.9 million, $13.0 million and $11.5 million, respectively.

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Quarterly Results in 2013

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Fiscal year 2013				
Revenues	$253.3	$235.2	$226.4	$235.7
Gross profit	$65.8	$60.4	$52.3	$61.5
Operating income (loss) from continuing operations	$11.4	$8.9	$6.1	$5.4
Provision (benefit) for income taxes	$2.8	$(0.1)	$0.2	$(2.9)
Net loss	$(10.3)	$(9.6)	$(9.9)	$(7.4)
Net loss per common share:				
Basic and diluted	$(0.18)	$(0.17)	$(0.17)	$(0.12)

In the third quarter the Company had a benefit of $4.7 million primarily related to an adjustment to the liability for unused office space which was primarily due to a change in the estimated excess facility accrual of office space at our Colombia, Maryland administrative facilities partially offset by $2.0 million of expenses related to workforce reductions as a result of cost reduction initiatives we have implemented across the Company. Also included in each of the first, second, third and fourth quarter is amortization of purchased intangibles of $9.3 million, $9.0 million, $9.0 million and $8.9 million, respectively.

Note 17. Condensed Consolidating Financial Statements

The Company has $625.0 million in outstanding Notes. See Note 5. The Notes are guaranteed by all of the Company's 100% owned domestic subsidiaries (the "Subsidiary Guarantors") and are collateralized by the assets of all of the Company's 100% owned subsidiaries. The Notes are fully and unconditionally guaranteed on a joint and several basis by each guarantor subsidiary and the Company. There are no contractual restrictions limiting cash transfers from guarantor subsidiaries by dividends, loans or advances to the Company. The Notes are not guaranteed by the Company's foreign subsidiaries (the “Non-Guarantor Subsidiaries”).

The following tables present condensed consolidating financial statements for the parent company, the Subsidiary Guarantors and the Non-Guarantor Subsidiaries, respectively, for 2011, 2012, and 2013. The consolidating financial information below follows the same accounting policies as described in the Consolidated Financial Statements, except for the use of the equity method of accounting to reflect ownership interests in wholly-owned subsidiaries, which are eliminated upon consolidation.

Subsequent to the issuance of the Company’s consolidated financial statements for the years ended December 25, 2011 and December 30, 2012, the Company reclassified Investment in affiliated companies to a separate line item in its Condensed Consolidating Statement of Cash Flows. These amounts were previously combined with financings from affiliated companies.

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Condensed Consolidating Balance Sheet
December 30, 2012

(in millions)

	Parent Company	Guarantors on a Combined Basis	Non-Guarantors on a Combined Basis	Eliminations	Consolidated
Assets					
Current Assets:					
Cash and cash equivalents	$37.8	$(4.0)	$ 15.2	$—	$49.0
Accounts receivable, net	—	253.5	18.4	—	271.9
Amounts due from affiliated companies	480.2	—	—	(480.2)	—
Inventoried costs	—	75.4	18.9	—	94.3
Other current assets	9.1	28.0	3.1	—	40.2
Total current assets	527.1	352.9	55.6	(480.2)	455.4
Property, plant and equipment, net	1.3	74.7	9.6	—	85.6
Goodwill	—	574.7	21.7	—	596.4
Intangible assets, net	—	103.4	2.7	—	106.1
Investment in subsidiaries	439.8	28.8	—	(468.6)	—
Amounts due from affiliated companies	—	24.0	—	(24.0)	—
Other assets	17.6	22.4	0.4	—	40.4
Total assets	$985.8	$1,180.9	$ 90.0	$(972.8)	$1,283.9
Liabilities and Stockholders' Equity					
Current liabilities:					
Accounts payable	$2.8	$75.2	$ 5.6	$—	$83.6
Accrued expenses	7.0	42.3	3.4	—	52.7
Accrued compensation	2.9	41.8	3.1	—	47.8
Billings in excess of costs and earnings on uncompleted contracts	—	40.5	3.2	—	43.7
Deferred tax liability	—	28.9	—	—	28.9
Amounts due to affiliated companies	—	455.1	25.1	(480.2)	—
Other current liabilities	1.1	19.1	1.9	—	22.1
Total current liabilities	13.8	702.9	42.3	(480.2)	278.8
Long-term debt, net of current portion	643.6	—	4.8	—	648.4
Deferred tax liability	—	—	—	—	—
Amounts due to affiliated companies	—	—	24.0	(24.0)	—
Other long-term liabilities	4.3	26.2	2.1	—	32.6
Total liabilities	661.7	729.1	73.2	(504.2)	959.8
Total stockholders' equity	324.1	451.8	16.8	(468.6)	324.1
Total liabilities and stockholders' equity	$985.8	$1,180.9	$ 90.0	$(972.8)	$1,283.9

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Condensed Consolidating Balance Sheet
December 29, 2013

(in millions)

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

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Condensed Consolidating Statement of Operations and Comprehensive Income (Loss)
Year Ended December 25, 2011
(in millions)

	Parent Company	Guarantors on a Combined Basis	Non-Guarantors on a Combined Basis	Eliminations	Consolidated
Service revenues	$—	$349.3	$ 1.7	$—	$351.0
Product sales	—	327.4	46.9	(11.4)	362.9
Total revenues	—	676.7	48.6	(11.4)	713.9
Cost of service revenues	—	259.2	1.5	—	260.7
Cost of product sales	—	242.5	30.9	(11.4)	262.0
Total costs	—	501.7	32.4	(11.4)	522.7
Gross profit	—	175.0	16.2	—	191.2
Selling, general and administrative expenses	15.9	122.3	14.9	—	153.1
Research and development expenses	—	7.9	0.7	—	8.6
Operating income (loss) from continuing operations	(15.9)	44.8	0.6	—	29.5
Other income (expense):					
Interest expense, net	(50.8)	0.1	(0.4)	—	(51.1)
Other income, net	0.3	0.4	(0.7)	—	—
Total other income and expense, net	(50.5)	0.5	(1.1)	—	(51.1)
Income (loss) from continuing operations before income taxes	(66.4)	45.3	(0.5)	—	(21.6)
Provision (benefit) for income taxes from continuing operations	—	3.0	(1.1)	—	1.9
Income (loss) from continuing operations	(66.4)	42.3	0.6	—	(23.5)
Income (loss) from discontinued operations	—	(0.8)	0.1	—	(0.7)
Equity in net income (loss) of subsidiaries	42.2	0.5	—	(42.7)	—
Net income (loss)	$(24.2)	$42.0	$ 0.7	$(42.7)	$(24.2)
Comprehensive income (loss)	$(24.4)	$41.7	$ 0.8	$(42.5)	$(24.4)

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Condensed Consolidating Statement of Operations and Comprehensive Income (Loss)
Year Ended December 30, 2012
(in millions)

	Parent Company	Guarantors on a Combined Basis	Non-Guarantors on a Combined Basis	Eliminations	Consolidated
Service revenues	$—	$448.5	$ 1.5	$—	$450.0
Product sales	—	470.0	64.5	(15.3)	519.2
Total revenues	—	918.5	66.0	(15.3)	969.2
Cost of service revenues	—	350.0	0.8	—	350.8
Cost of product sales	—	333.8	42.7	(15.3)	361.2
Total costs	—	683.8	43.5	(15.3)	712.0
Gross profit	—	234.7	22.5	—	257.2
Selling, general and administrative expenses	7.4	171.2	13.9	—	192.5
Impairment of goodwill and intangibles	—	96.6	—	—	96.6
Research and development expenses	—	16.9	0.9	—	17.8
Operating income (loss) from continuing operations	(7.4)	(50.0)	7.7	—	(49.7)
Other income (expense):					
Interest expense, net	(65.9)	0.3	(0.5)	—	(66.1)
Other income, net	0.3	0.1	0.9	—	1.3
Total other income and expense, net	(65.6)	0.4	0.4	—	(64.8)
Income (loss) from continuing operations before income taxes	(73.0)	(49.6)	8.1	—	(114.5)
Provision (benefit) for income taxes from continuing operations	20.8	(22.8)	0.4	—	(1.6)
Income (loss) from continuing operations	(93.8)	(26.8)	7.7	—	(112.9)
Income (loss) from discontinued operations	(0.1)	(2.2)	0.8	—	(1.5)
Equity in net income (loss) of subsidiaries	(20.5)	8.3	—	12.2	—
Net income (loss)	$(114.4)	$(20.7)	$ 8.5	$12.2	$(114.4)
Comprehensive income (loss)	$(115.0)	$20.9	$ 9.4	$11.5	$(115.0)

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Condensed Consolidating Statement of Operations and Comprehensive Income (Loss)
Year Ended December 29, 2013
(in millions)

	Parent Company	Guarantors on a Combined Basis	Non-Guarantors on a Combined Basis	Eliminations	Consolidated
Service revenues	—	438.2	5.4	—	443.6
Product sales	—	448.6	75.3	(16.9)	507.0
Total revenues	—	886.8	80.7	(16.9)	950.6
Cost of service revenues	—	331.3	3.9	—	335.2
Cost of product sales	—	338.9	53.4	(16.9)	375.4
Total costs	—	670.2	57.3	(16.9)	710.6
Gross profit	—	216.6	23.4	—	240.0
Selling, general and administrative expenses	5.5	167.2	14.1	—	186.8
Impairment of goodwill and intangibles	—	—	—	—	—
Research and development expenses	—	20.2	1.2	—	21.4
Operating income (loss) from continuing operations	(5.5)	29.2	8.1	—	31.8
Other income (expense):					
Interest expense, net	(65.6)	2.3	(0.4)	—	(63.7)
Other income, net	—	(0.3)	0.3	—	—
Total other income and expense, net	(65.6)	2.0	(0.1)	—	(63.7)
Income (loss) from continuing operations before income taxes	(71.1)	31.2	8.0	—	(31.9)
Provision (benefit) for income taxes from continuing operations	0.6	(0.7)	0.1	—	—
Income (loss) from continuing operations	(71.7)	31.9	7.9	—	(31.9)
Income (loss) from discontinued operations	0.1	(5.4)	—	—	(5.3)
Equity in net income (loss) of subsidiaries	34.4	7.9	—	(42.3)	—
Net income (loss)	$(37.2)	$34.4	$ 7.9	$(42.3)	$(37.2)
Comprehensive income (loss)	$(37.2)	$34.4	$ 7.9	$(42.3)	$(37.2)

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Condensed Consolidating Statement of Cash Flows
Year Ended December 25, 2011
(in millions)

	Parent Company	Guarantors on a Combined Basis	Non-Guarantors on a Combined Basis	Eliminations	Consolidated
Net cash provided by (used in) operating activities	$(55.1)	$60.5	$ (0.2)	$—	$5.2
Investing activities:					
Cash paid for acquisitions, net of cash acquired	(421.0)	18.0	11.9	—	(391.1)
Decrease in restricted cash	1.4	1.6	—	—	3.0
Investment in affiliated companies	—	(68.6)	—	68.6	—
Capital expenditures	(0.2)	(6.3)	(1.0)	—	(7.5)
Net cash provided by (used in) investing activities from continuing operations	(419.8)	(55.3)	10.9	68.6	(395.6)
Financing activities:					
Proceeds from the issuance of common stock	61.1	—	—	—	61.1
Proceeds from the issuance of long-term debt	425.7	—	—	—	425.7
Debt issuance costs paid	(22.1)	—	—	—	(22.1)
Purchase of treasury stock	(10.9)	—	—	—	(10.9)
Repayment of debt	—	(2.6)	(0.8)	—	(3.4)
Financing from affiliated companies	63.6	—	5.0	(68.6)	—
Other, net	2.0	—	—	—	2.0
Net cash provided by (used in) financing activities from continuing operations	519.4	(2.6)	4.2	(68.6)	452.4
Net cash flows of continuing operations	44.5	2.6	14.9	—	62.0
Net operating cash flows from discontinued operations	—	(2.2)	(0.5)	—	(2.7)
Effect of exchange rate changes on cash and cash equivalents	—	(0.3)	(0.2)		(0.5)
Net increase in cash and cash equivalents	$44.5	$0.1	$ 14.2	$—	$58.8

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Condensed Consolidating Statement of Cash Flows
Year Ended December 30, 2012
(in millions)

	Parent Company	Guarantors on a Combined Basis	Non-Guarantors on a Combined Basis	Eliminations	Consolidated
Net cash provided by (used in) operating activities	$(98.2)	$144.5	$ 6.0	$—	$52.3
Investing activities:		—	—		
Cash paid for acquisitions, net of cash acquired	2.3	(151.7)	—	—	(149.4)
Decrease in restricted cash	—	0.6	—	—	0.6
Investment in affiliated companies	(10.8)	—	(2.0)	12.8	—
Capital expenditures	(0.5)	(14.2)	(1.9)	—	(16.6)
Other, net	—	0.3	—	—	0.3
Net cash provided by (used in) investing activities from continuing operations	(9.0)	(165.0)	(3.9)	12.8	(165.1)
Financing activities:					
Proceeds from the issuance of common stock	97.0	—	—	—	97.0
Debt issuance costs paid	(1.2)	—	—	—	(1.2)
Repayment of debt	—	(0.5)	(1.0)	—	(1.5)
Financings from affiliated companies	—	12.8	—	(12.8)	—
Other, net	(3.4)	—	—	—	(3.4)
Net cash provided by (used in) financing activities from continuing operations	92.4	12.3	(1.0)	(12.8)	90.9
Net cash flows of continuing operations	(14.8)	(8.2)	1.1	—	(21.9)
Net operating cash flows from discontinued operations	—	1.3	—	—	1.3
Effect of exchange rate changes on cash and cash equivalents	—	—	—		—
Net increase (decrease) in cash and cash equivalents	$(14.8)	$(6.9)	$ 1.1	$—	$(20.6)

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Condensed Consolidating Statement of Cash Flows
Year Ended December 29, 2013
(in millions)

	Parent Company	Guarantors on a Combined Basis	Non-Guarantors on a Combined Basis	Eliminations	Consolidated
Net cash provided by (used in) operating activities	$(65.9)	$87.5	$ 1.0	$—	$22.6
Investing activities:		—	—		
Cash paid for acquisitions, net of cash acquired	—	2.2	—	—	2.2
Decrease in restricted cash	—	0.4	—	—	0.4
Proceeds from the sale of discontinued operations	—	1.3	—	—	1.3
Investment in affiliated companies	—	(74.8)	—	74.8	—
Capital Expenditures	(1.4)	(12.3)	(2.9)	—	(16.6)
Net cash provided by (used in) investing activities from continuing operations	(1.4)	(83.2)	(2.9)	74.8	(12.7)
Financing activities:					
Cash paid for contingent acquisition consideration	—	(2.1)	—	—	(2.1)
Repayment of debt	—	—	(1.0)	—	(1.0)
Purchase of ESPP shares	1.1	—	—	—	1.1
Financings from affiliated companies	71.1	—	3.7	(74.8)	—
Other, net	—	—	—	—	—
Net cash provided by (used in) financing activities from continuing operations	72.2	(2.1)	2.7	(74.8)	(2.0)
Net cash flows of continuing operations	4.9	2.2	0.8	—	7.9
Net operating cash flows from discontinued operations	—	(1.3)	—	—	(1.3)
Effect of exchange rate changes on cash and cash equivalents	—	—	0.1	—	0.1
Net increase (decrease) in cash and cash equivalents	$4.9	$0.9	$ 0.9	$—	$6.7