KRATOS DEFENSE & SECURITY SOLUTIONS, INC.
Form S-4/A
May 22, 2008

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As filed with the Securities and Exchange Commission on May 22, 2008

Registration No. 333-150165

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Amendment No. 2
to
Form S-4

REGISTRATION STATEMENT UNDER THE SECURITIES ACT OF 1933

KRATOS DEFENSE & SECURITY SOLUTIONS, INC.

(Exact name of registrant as specified in its charter)

Delaware	**4899**	**13-3818604**
(State or other jurisdiction of incorporation or organization)	(Primary Standard Industrial Classification Code Number)	(I.R.S. Employer Identification Number)

4810 Eastgate Mall
San Diego, CA 92121
(858) 812-7300
(Address, including zip code, and telephone number, including area code, of registrant's principal executive offices)

Eric DeMarco
President and Chief Executive Officer
4810 Eastgate Mall
San Diego, CA 92121
(858) 812-7300
(Name, address, including zip code, and telephone number, including area code, of agent for service)

Copies to:
WITH A COPY TO

Marty B. Lorenzo	**Otto E. Sorensen**
Sagar M. Brahmbhatt	Luce, Forward, Hamilton & Scripps LLP
DLA Piper US LLP	600 West Broadway, Suite 2600
4365 Executive Drive, Suite 1100	San Diego, California 92101
San Diego, CA 92121	(619) 699-2534
(858) 677-1400	(619) 645-5324 (facsimile)
(858) 677-1401 (facsimile)	

Approximate date of commencement of proposed sale of the securities to the public:
As soon as practicable after this registration statement becomes effective and all other conditions to the proposed merger described

herein have been satisfied or waived.

If the securities being registered on this Form are being offered in connection with the formation of a holding company and there is compliance with General Instruction G, check the following box. o

If this Form is filed to register additional securities for an offering pursuant to Rule 462(b) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. o

If this Form is a post-effective amendment filed pursuant to Rule 462(d) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. o

The Registrant hereby amends this Registration Statement on such date or dates as may be necessary to delay its effective date until the Registrant shall file a further Amendment which specifically states that this Registration Statement shall thereafter become effective in accordance with Section 8(a) of the Securities Act of 1933 or until the Registration Statement shall become effective on such date as the Commission, acting pursuant to said Section 8(a), may determine.

PROPOSED MERGER YOUR VOTE IS VERY IMPORTANT

Each of the boards of directors of Kratos Defense & Security Solutions, Inc., a Delaware corporation ("***Kratos***") and SYS, a California corporation ("***SYS***"), has approved a strategic merger, combining Kratos and SYS. We believe that the proposed merger will allow Kratos and SYS to be better positioned to compete in the rapidly evolving defense and security solutions industry.

Kratos and SYS have entered into an Agreement and Plan of Merger and Reorganization pursuant to which SYS will merge with a newly formed, wholly-owned subsidiary of Kratos, with SYS surviving the merger as a wholly-owned subsidiary of Kratos.

In the proposed merger, SYS shareholders will receive 1.2582 shares of Kratos common stock for each share of SYS common stock. This exchange ratio is fixed and will not be adjusted to reflect stock price changes prior to the closing. The stockholders of Kratos will continue to own their existing shares, which will not be affected by the merger. Upon completion of the merger, SYS's former shareholders will own approximately 24% of the then outstanding shares of Kratos common stock, based on the number of shares of Kratos and SYS common stock expected to be outstanding on the closing of the merger. The value of the merger consideration to be received in exchange for each share of SYS common stock will fluctuate with the market price of Kratos common stock.

Based on the closing sale price for Kratos common stock on February 20, 2008, the last trading day before public announcement of the merger, the 1.2582 exchange ratio represented approximately $2.65 in value for each share of SYS common stock. Based on the closing sale price for Kratos common stock on May 19, 2008, the latest practicable date before the printing of this joint proxy statement/prospectus, which we refer to as this Proxy Statement, the 1.2582 exchange ratio represented approximately $2.24 in value for each share of SYS common stock.

Kratos common stock is listed on The Nasdaq Global Select Market under the symbol "KTOS." SYS common stock is listed on the American Stock Exchange under the symbol "SYS." We urge you to obtain current market quotations for the shares of Kratos and SYS.

Your vote is very important. The merger cannot be completed unless Kratos stockholders approve the issuance of Kratos common stock and SYS shareholders adopt and approve the merger agreement. Each of Kratos and SYS is holding a meeting of its stockholders to vote on the proposals necessary to complete the merger, and in the case of Kratos, to approve certain other matters described in this Proxy Statement. Information about these meetings, the merger and the other business to be considered by stockholders is contained in this Proxy Statement. We urge you to read this Proxy Statement carefully. **You should also carefully consider the risk factors beginning on page 24.**

Whether or not you plan to attend your respective company's meeting of stockholders, please submit your proxy as soon as possible to make sure that your shares are represented at that meeting.

The Kratos board of directors unanimously recommends that Kratos stockholders vote FOR the proposal to approve the issuance of Kratos common stock, which is necessary to effect the merger.

The SYS board of directors unanimously recommends that SYS shareholders vote FOR the proposal to adopt and approve the merger agreement.

Eric M. DeMarco	Clifton L. Cooke, Jr.
Chief Executive Officer and President	*President and Chief Executive Officer*
Kratos Defense & Security Solutions, Inc.	SYS

Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved of the securities to be issued in connection with the merger or determined if this Proxy Statement is accurate or complete. Any representation to the contrary is a criminal offense.

This Proxy Statement is dated May 22, 2008, and is first being mailed to stockholders of Kratos and SYS on or about May 27, 2008.

NOTICE OF ANNUAL MEETING OF STOCKHOLDERS TO BE HELD ON JUNE 25, 2008

To the Stockholders of Kratos Defense & Security Solutions, Inc.:

An annual meeting of stockholders of Kratos Defense & Security Solutions, Inc. will be held at , on June 25, 2008 at 3:00 p.m., local time, for the following purposes:

1. To elect five directors for one-year terms or until their successors are elected and duly qualified.

2. To ratify the selection of Grant Thornton LLP as Kratos' independent auditors for the fiscal year ending December 28, 2008.

3. To approve an amendment to the Kratos 1999 Employee Stock Purchase Plan to increase the aggregate number of shares that may be issued under the plan by 1,500,000 shares.

4. To approve an amendment to the Kratos 2005 Equity Incentive Plan to increase the aggregate number of shares that may be issued under the plan by 3,000,000 shares.

5. To approve the issuance of Kratos common stock, par value $0.001 per share, pursuant to the Agreement and Plan of Merger and Reorganization, dated as of February 20, 2008, by and among Kratos Defense & Security Solutions, Inc., White Shadow, Inc., and SYS, as the same may be amended from time to time (the "***Share Issuance***").

6. To approve any motion to adjourn or postpone the annual meeting to a later date or dates, if necessary, to solicit additional proxies if there are insufficient votes at the time of the annual meeting to approve the first five proposals listed above.

7. To transact such other business as may properly come before the annual meeting or any adjournment or postponement thereof.

The accompanying Proxy Statement further describes the matters to be considered at the meeting. A copy of the Agreement and Plan of Merger referenced above has been included as *Annex A* to the Proxy Statement.

The Kratos board of directors has set May 19, 2008 as the record date for the annual meeting. Only holders of record of Kratos common stock at the close of business on May 19, 2008 will be entitled to notice of and to vote at the annual meeting and any adjournments or postponements thereof. Any stockholder entitled to attend and vote at the meeting is entitled to appoint a proxy to attend and vote on such stockholder's behalf. Such proxy need not be a holder of Kratos common stock. **To ensure your representation at the annual meeting, please complete and return the enclosed proxy card or submit your proxy by telephone or through the Internet.** Please vote promptly whether or not you expect to attend the annual meeting. Submitting a proxy now will not prevent you from being able to vote at the annual meeting by attending in person and casting a vote.

The Kratos board of directors unanimously recommends that you vote FOR the proposal to elect five directors for one-year terms or until their successors are elected and duly qualified; FOR the proposal to ratify the selection of Grant Thornton LLP as Kratos' independent auditors for the fiscal year ending December 28, 2008; FOR the proposal to approve an amendment to the Kratos 1999 Employee Stock Purchase Plan to increase the aggregate number of shares that may be issued under the plan by 1,500,000 shares; FOR the proposal to approve an amendment to the Kratos 2005 Equity Incentive Plan to increase aggregate number of shares that may be issued under the plan by 3,000,000 shares; FOR the proposal to approve the Share Issuance; and FOR the proposal to approve any motion to adjourn or postpone the annual meeting to a later date or dates if necessary to solicit additional proxies.

By Order of the Kratos Board of Directors,

Eric M. DeMarco
President and Chief Executive Officer
San Diego, CA
May 22, 2008

PLEASE VOTE YOUR SHARES PROMPTLY. YOU CAN FIND INSTRUCTIONS FOR VOTING ON THE ENCLOSED PROXY CARD. IF YOU HAVE QUESTIONS ABOUT THE PROPOSALS OR ABOUT VOTING YOUR SHARES, PLEASE CALL KRATOS' PROXY SOLICITOR GEORGESON, INC. AT (800) 561-4162 (TOLL FREE).

NOTICE OF SPECIAL MEETING OF SHAREHOLDERS TO BE HELD ON JUNE 24, 2008

To the Shareholders of SYS:

A special meeting of shareholders of SYS will be held at 5050 Murphy Canyon Road, Suite 200, San Diego, CA 92123, on June 24, 2008 at 11:00 a.m., local time, for the following purposes:

1. To adopt and approve the Agreement and Plan of Merger and Reorganization, dated as of February 20, 2008, by and among Kratos Defense & Security Solutions, Inc., White Shadow, Inc., and SYS, as the same may be amended from time to time.

2. To approve any motion to adjourn or postpone the special meeting to a later date or dates, if necessary, to solicit additional proxies if there are insufficient votes at the time of the special meeting to approve the proposal to adopt the merger agreement.

3. To transact such other business as may properly come before the special meeting or any adjournment or postponement thereof.

The accompanying Proxy Statement further describes the matters to be considered at the special meeting. A copy of the Agreement and Plan of Merger referenced above has been included as *Annex A* to this Proxy Statement.

The SYS board of directors has set May 15, 2008 as the record date for the special meeting. Only holders of record of shares of SYS common stock at the close of business on May 15, 2008 will be entitled to notice of and to vote at the special meeting and any adjournments or postponements thereof. **To ensure your representation at the special meeting, please complete and return the enclosed proxy card or submit your proxy by telephone or through the Internet.** Please vote promptly whether or not you expect to attend the special meeting. Submitting a proxy now will not prevent you from being able to vote at the special meeting by attending in person and casting a vote.

The board of directors of SYS recommends that you vote FOR the proposal to adopt and approve the merger agreement and FOR the proposal to approve any motion to adjourn or postpone the special meeting to a later date or dates if necessary to solicit additional proxies.

By Order of the SYS Board of Directors,

Clifton L. Cooke, Jr.
President and Chief Executive Officer
May 20, 2008

PLEASE VOTE YOUR SHARES PROMPTLY. YOU CAN FIND INSTRUCTIONS FOR VOTING ON THE ENCLOSED PROXY CARD. IF YOU HAVE QUESTIONS ABOUT THE PROPOSALS OR ABOUT VOTING YOUR SHARES, PLEASE CALL MICHAEL W. FINK AT 858-244-7393 (TOLL FREE) OR VIA EMAIL AT *MFINK@SYSTECHNOLOGIES.COM.*

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VOTING ELECTRONICALLY OR BY TELEPHONE

Kratos stockholders of record on the close of business on May 19, 2008, the record date for the Kratos annual meeting, may submit their proxies by telephone or Internet by following the instructions on their proxy card or voting form. If you have any questions regarding whether you are eligible to submit your proxy by telephone or by Internet, please contact Kratos' Proxy Solicitor, Georgeson, Inc. by telephone at (800) 561-4162 (toll free).

SYS shareholders of record on the close of business on May 15, 2008, the record date for the SYS special meeting, may submit their proxies by telephone or Internet by following the instructions on their proxy card or voting form. If you have any questions regarding whether you are eligible to submit your proxy by telephone or by Internet, please contact Michael W. Fink by telephone at 858-244-7393 or via email at *mfink@systechnologies.com*.

QUESTIONS AND ANSWERS ABOUT THE MEETINGS

The following questions and answers briefly address some commonly asked questions about the Kratos and SYS meetings. They may not include all the information that is important to holders of stock of Kratos and SYS. We urge stockholders to read carefully this entire Proxy Statement, including the annexes and the other documents referred to herein.

Q:

Why am I receiving these materials?

A:

We are sending you these materials to help you decide how to vote your shares of Kratos or SYS common stock with respect to their proposed merger. Additionally, if you are a Kratos stockholder, we are sending these materials to you to help you decide how to vote your shares of Kratos common stock with respect to the other proposals at the Kratos annual meeting.

The merger cannot be completed unless Kratos stockholders approve the issuance of Kratos common stock and SYS shareholders adopt and approve the merger agreement. Each of Kratos and SYS is holding its meeting of holders of stock to vote on the proposals necessary to complete the merger. Information about these meetings, the merger and the other business to be considered by holders of stock is contained in this Proxy Statement.

We are delivering this document to you as both a joint proxy statement of Kratos and SYS and a prospectus of Kratos. It is a joint proxy statement because each of our boards of directors is soliciting proxies from its stockholders. It is a prospectus because Kratos will exchange shares of its common stock for shares of SYS in the merger.

Q:

What will stockholders receive in the merger?

A:

In the proposed merger, holders of SYS common stock will receive 1.2582 shares of Kratos common stock for each share of SYS common stock. This exchange ratio is fixed and will not be adjusted to reflect stock price changes prior to the closing.

The stockholders of Kratos will continue to own their existing shares, which will not be affected by the merger.

Q:

When do Kratos and SYS expect to complete the merger?

A:

Kratos and SYS expect to complete the merger after all conditions to the merger in the merger agreement are satisfied or waived, including after stockholder approvals are received at the meetings of Kratos and SYS and all required regulatory approvals are received. Kratos and SYS currently expect to complete the merger during the first half of 2008. However, it is possible that factors outside of either company's control could require Kratos and SYS to complete the merger at a later time or not to complete it at all.

Q:

How do the boards of directors of Kratos and SYS recommend that I vote?

A:

The Kratos board of directors unanimously recommends that holders of Kratos common stock vote FOR the proposal to approve the issuance of Kratos common stock in the merger.

The SYS board of directors unanimously recommends that SYS shareholders vote FOR the proposal to adopt the merger agreement.

Q:

What do I need to do now?

A:

After carefully reading and considering the information contained in this Proxy Statement, please vote your shares as soon as possible so that your shares will be represented at your respective company's meeting. Please follow the instructions set forth on the proxy card or on the voting instruction form provided by the record holder if your shares are held in the name of your broker or other nominee.

Q: **How do I vote?**

A: You may vote before your company's meeting in one of the following ways:

- use the toll-free number shown on your proxy card;
- visit the website shown on your proxy card to vote via the Internet; or
- complete, sign, date and return the enclosed proxy card in the enclosed postage-paid envelope.

You may also cast your vote in person at your company's meeting.

If your shares are held in "street name" through a broker, bank or other nominee, that institution will send you separate instructions describing the procedure for voting your shares. "Street name" stockholders who wish to vote at the meeting will need to obtain a proxy form from the institution that holds their shares.

Q: **When and where are the Kratos and SYS meetings of stockholders?**

A: The annual meeting of Kratos stockholders will be held at 4810 Eastgate Mall, San Diego, CA, on June 25, 2008 at 3:00 p.m., local time. Subject to space availability, all stockholders as of the record date, or their duly appointed proxies, may attend the meeting. Since seating is limited, admission to the meeting will be on a first-come, first-served basis. Registration and seating will begin at 2:00 p.m., local time.

The special meeting of SYS shareholders will be held at 5050 Murphy Canyon Road, Suite 200, San Diego, CA 92123, on June 24, 2008 at 11:00 a.m., local time. Subject to space availability, all stockholders as of the record date, or their duly appointed proxies, may attend the meeting. Since seating is limited, admission to the meeting will be on a first-come, first-served basis. Registration and seating will begin at 10:00 a.m., local time.

Q: **If my shares are held in "street name" by a broker or other nominee, will my broker or nominee vote my shares for me?**

A: Your broker or other nominee does not have authority to vote on most of the proposals described in this Proxy Statement including the proposals related to the proposed merger. Your broker or other nominee will vote your shares held by it in "street name" with respect to these matters ONLY if you provide instructions to it on how to vote. You should follow the directions your broker or other nominee provides.

Q: **What constitutes a quorum?**

Stockholders who hold a majority in voting power of the Kratos common stock issued and outstanding as of the close of business on the record date and who are entitled to vote must be present or represented by proxy in order to constitute a quorum to conduct business at the Kratos annual meeting.

Stockholders who hold a majority in voting power of the SYS common stock issued and outstanding as of the close of business on the record date and who are entitled to vote must be present or represented by proxy in order to constitute a quorum to conduct business at the SYS special meeting.

Q: **What vote is required to approve each proposal?**

A: For Kratos Stockholders:

Other than the proposal for the election of directors, the affirmative vote of a majority of the total votes represented at the meeting in person or by proxy at a meeting at which a quorum is present is required to approve the Kratos proposals, including the proposal to approve the issuance of

Kratos common stock in the merger, which is referred to in this Proxy Statement as the Share Issuance.

For SYS Shareholders:

The affirmative vote of a majority of the outstanding shares of SYS common stock entitled to vote is required to approve the merger agreement, which is referred to in this Proxy Statement as the Merger Proposal.

Q:

What if I do not vote on the matters relating to the merger?

A:

If you are a Kratos stockholder and you fail to vote or fail to instruct your broker or other nominee how to vote on the Share Issuance, it will have no effect on the vote for the Share Issuance. If you respond with an "abstain" vote, your proxy will have the same effect as a vote against this proposal. If you submit a proxy but do not indicate how you want to vote on the Share Issuance, your proxy will be counted as a vote in favor of the Share Issuance in accordance with the recommendation of the Kratos Board.

If you are an SYS shareholder and you fail to vote or fail to instruct your broker or other nominee how to vote on the Merger Proposal, it will have the same effect as a vote against the Merger Proposal. If you respond with an "abstain" vote on the Merger Proposal, your proxy will have the same effect as a vote against the Merger Proposal. If you respond but do not indicate how you want to vote on the Merger Proposal, your proxy will be counted as a vote in favor of the Merger Proposal.

Q:

What if I hold shares in both Kratos and SYS?

A.

If you are a stockholder of both Kratos and SYS, you will receive two separate packages of proxy materials. A vote as a Kratos stockholder approving the issuance of Kratos common stock will not constitute a vote as an SYS shareholder for the Merger Proposal, or vice versa. Therefore, please sign, date and return all proxy cards that you receive, whether from Kratos or SYS, or vote as both a Kratos and SYS shareholder by telephone or via the Internet.

Q:

May I change my vote after I have delivered my proxy or voting instruction card?

A:

Yes. You may change your vote at any time before your proxy is voted at the applicable meeting. You may do this in one of four ways:

- by sending a notice of revocation to the corporate secretary of Kratos or SYS, as applicable;

- by sending a completed proxy card bearing a later date than your original proxy card;

- by logging onto the Internet website specified on your proxy card in the same manner you would to submit your proxy electronically or by calling the telephone number specified on your proxy card, in each case if you are eligible to do so and following the instructions on the proxy card; or

- by attending the applicable meeting and voting in person. Your attendance alone will not revoke any proxy.

If you choose any of the first three methods, you must take the described action no later than the beginning of the applicable meeting.

If your shares are held in an account at a broker or other nominee, you should contact your broker or other nominee to change your vote.

Q:

What are the material United States federal income tax consequences of the merger?

A:

Kratos and SYS intend for the merger to qualify as a reorganization within the meaning of Section 368(a) of the Internal Revenue Code of 1986, as amended, which we refer to as the Code, for United States federal income tax purposes. Accordingly, a holder of SYS common stock generally will not recognize any gain or loss for U.S. federal income tax purposes upon the exchange of the holder's shares of SYS common stock for shares of Kratos common stock pursuant to the merger, except that an SYS shareholder will recognize a gain or loss with respect to any cash received in lieu of a fractional share of Kratos common stock.

Q:

Do I have appraisal rights?

A:

The holders of Kratos common stock will not be entitled to exercise any appraisal rights in connection with the merger. Pursuant to Section 1300 of the California Corporations Code, the holders of SYS common stock are entitled to appraisal rights if they do not vote in favor of the merger and otherwise comply with the requirements of Chapter 13 of the California General Corporation Law.

Q:

Should I send in my stock certificates now?

A:

No. Please do not send your stock certificates with your proxy card.

If you are a holder of SYS common stock, you will receive written instructions from the exchange agent after the merger is completed on how to exchange your stock certificates for Kratos common stock. Kratos stockholders will not be exchanging their stock certificates in connection with the merger. Accordingly, Kratos stockholders holding stock certificates should keep their stock certificates both now and after the merger is completed.

Q:

What if I hold SYS and Kratos stock options or other stock-based awards?

A:

Kratos stock options and other equity-based awards, including restricted stock units, will remain outstanding and will not be affected by the merger.

All outstanding SYS stock options will become fully vested prior to the closing. The stock options may be exercised for SYS shares ("cashless exercise" being permissible) at or prior to closing in accordance with the terms of the stock option plans which shares would then be exchanged for Kratos shares in accordance with the exchange ratio. Any such stock option exercises may be subject to withholding taxes as a result. No outstanding SYS stock options will be assumed by or converted into options of Kratos.

Q:

Who should I contact if I have any questions about the merger, the proxy materials or voting power?

A:

If you have any questions about the merger or if you need assistance in submitting your proxy or voting your shares or need additional copies of the Proxy Statement or the enclosed proxy card, you should contact the company in which you hold shares.

If you are a Kratos stockholder, you should contact Georgenson, Inc., the proxy solicitation agent for Kratos at (800) 561-4162 (toll-free). If you are an SYS shareholder, you should contact Michael W. Fink at 858-244-7393 or via email at mfink@systechnologies.com for SYS. If your shares are held in a stock brokerage account or by a bank or other nominee, you should call your broker or other nominee for additional information.

SUMMARY

This summary highlights selected information contained in this joint proxy statement/prospectus, referred to as this Proxy Statement, and does not contain all the information that may be important to you. Kratos and SYS urge you to read carefully this Proxy Statement in its entirety, including the annexes. Unless stated otherwise, all references in this Proxy Statement to Kratos refer to Kratos Defense & Security Solutions, Inc., a Delaware corporation, all references to SYS refer to SYS, a California corporation, all references to Merger Sub refer to White Shadow, Inc., a California corporation, and all references *to the merger agreement refer to the Agreement and Plan of Merger and Reorganization, dated as of February 20, 2008, by and among Kratos, White Shadow, Inc., and SYS, a copy of which is attached as Annex A to this Proxy Statement.*

The Merger

Each of the boards of directors of Kratos and SYS has approved a strategic merger of Kratos and SYS. Kratos and SYS have entered into an Agreement and Plan of Merger and Reorganization pursuant to which SYS will merge with a newly formed, wholly-owned subsidiary of Kratos, with SYS surviving the merger as a wholly-owned subsidiary of Kratos. In the proposed merger, SYS shareholders will receive 1.2582 shares of Kratos common stock for each share of SYS common stock. This exchange ratio is fixed and will not be adjusted to reflect stock price changes prior to the closing. The stockholders of Kratos will continue to own their existing shares, which will not be affected by the merger.

The Parties

Kratos

Kratos Defense & Security Solutions, Inc.
4810 Eastgate Mall
San Diego, CA 92121
(858) 812-7300

Kratos is an innovative provider of mission critical engineering, IT services and warfighter solutions. Kratos performs work primarily for the U.S. government and government agencies, but also performs work for state and local agencies and commercial customers. As a result of its market focus, Kratos is organized into two primary operating segments: the Kratos Government Solutions, or KGS, segment; and the Public Safety and Security, or PSS, segment. The principle services of Kratos include, but are not limited to, Command, Control, Communications, Computing, Combat Systems, Intelligence, Surveillance and Reconnaissance, or C5ISR; weapon systems life cycle support and extension; military range operations and technical services; missile, rocket and weapons systems test and evaluation; mission launch services; public safety; security and surveillance systems; advanced network engineering and IT services; and critical infrastructure design and integration services. Kratos offers its customers a range of solutions and technical expertise to support their mission-critical needs by leveraging skills across Kratos' core service areas.

Kratos derives a substantial portion of its revenue from contracts performed for federal government agencies. Kratos believes its diversified and stable client base, strong client relationships, broad array of contracts, considerable employee base possessing government security clearances, extensive list of past performance qualifications, and significant management and operational capabilities provides a sizable advantage and positions the company for continued growth. Founded in 1994, Kratos is headquartered in San Diego and has offices in California, Washington D.C. and several other locations in the U.S.

For more information regarding Kratos, visit *www.kratosdefense.com*. The information on the Kratos' website is not a part of this prospectus.

SYS

SYS
5050 Murphy Canyon Road, Suite 200
San Diego, CA 92123
(858) 244-7393

SYS and its subsidiaries provide information connectivity solutions that capture, analyze and present real-time information to customers in the Department of Defense, Department of Homeland Security, other government agencies and commercial companies. Using interoperable communications software, sensors, digital video broadcast and surveillance technologies, wireless networks, network management, decision-support tools and Net-Centric technologies, SYS's technical experts enhance complex decision-making. Founded in 1966, SYS is headquartered in San Diego and has principal offices in California and Virginia.

SYS delivers its solutions through two reportable segments, the Defense Solutions Group and the Public Safety, Security and Industrial Systems Group. The Defense Solutions Group focuses on engineering, technical and management services to Federal Government agencies. The Public Safety, Security and Industrial Systems Group focuses on providing "right-time" situation status and mission execution support solutions to government and commercial customers. Historically, SYS has generated revenues by providing information technology, systems integration and program and financial management services under long term contracts for the Department of Defense and in particular the U.S. Navy. More recently, SYS has expanded and leveraged its technical engineering services with complementary products and has broadened its customer base to include commercial enterprises and other governmental agencies beyond the Department of Defense.

These expanded products and services capabilities, together with SYS's longstanding expertise in situational awareness and systems engineering, have enabled SYS to develop a set of information technology solutions to complement SYS's services offerings for the Information Technology services and Public Safety and Security markets. SYS's customers in these markets such as federal, state and local governments, public safety first-responders, large corporations, schools and universities, all share a common need for decision support products and services that enhance or enable connecting real-time data to decision makers.

SYS also provides solution lifecycle support with program, financial, test and logistical services, including classroom and online training.

For additional information regarding SYS, visit *www.systechnologies.com*. The information on SYS's website is not a part of this prospectus.

Merger Sub

White Shadow, Inc., or Merger Sub, a wholly-owned subsidiary of Kratos, is a California corporation formed on February 19, 2008 for the sole purpose of effecting the merger. Upon completion of the merger, Merger Sub will merge with and into SYS, and SYS will become a wholly-owned subsidiary of Kratos.

Merger Sub has not conducted any activities other than those incidental to its formation and the matters contemplated by the merger agreement, including the preparation of applicable regulatory filings in connection with the merger.

The Merger Agreement

A copy of the merger agreement is attached as *Annex A* to this Proxy Statement. Kratos and SYS encourage you to read the entire merger agreement carefully because it is the principal document governing the merger. For more information on the merger agreement, see "The Merger Agreement" beginning on page 79.

What SYS shareholders Will Receive in the Merger

At the effective time of the merger, each outstanding share of SYS common stock will be converted into the right to receive 1.2582 shares of Kratos common stock in the merger, which number we refer to as the exchange ratio. Holders of SYS common stock will not receive any fractional Kratos shares in the merger. Instead, the total number of shares that each holder of SYS common stock will receive in the merger will be rounded down to the nearest whole number, and Kratos will pay cash for any resulting fractional share that an SYS shareholder otherwise would be entitled to receive. The amount of cash payable for a fractional share of Kratos common stock will be determined by multiplying the fraction by the average closing price for Kratos common stock on The Nasdaq Global Select Stock Market during the three days prior to the date the merger becomes effective.

Example: If you currently own 25 shares of SYS common stock, absent the treatment of fractional shares described above, you would be entitled to receive 31.455 (25 × 1.2582) shares of Kratos common stock. Since fractional shares will not be issued, you will be entitled to 31 shares of Kratos common stock and a check for the market value of 0.455 shares of Kratos common stock based on the average closing price during the three days prior to date the merger becomes effective.

The merger agreement provides for adjustments to the exchange ratio to reflect the effect of any stock split, stock dividend, reverse stock split, reclassification, recapitalization or other similar transaction with respect to Kratos common stock or SYS common stock that occurs prior to the effective date of the merger.

For a more complete description of the merger consideration, see "The Merger Agreement Consideration to be Received in the Merger" beginning on page 80.

Treatment of SYS Subordinated Convertible Notes and Warrants

SYS has $3,125,000 of convertible notes payable outstanding, which we refer to as the Notes, which are unsecured, subordinate to its bank debt, bear interest at 10% per annum payable quarterly, are due February 14, 2009 and are convertible at any time into shares of common stock at a conversion rate of $3.60 per share. These notes are being assumed by Kratos subject to those same terms and conditions.

If the Notes are not converted prior to the merger, following the merger the Notes will not be convertible into SYS common stock. Instead, they will be convertible into the merger consideration as if they had been converted into SYS common stock immediately prior to the merger.

SYS has 508,401 warrants outstanding, which will be, following the merger, exercisable for merger consideration.

Following the merger, the holders of these warrants shall have the right to receive, upon exercise of the warrants, the same amount and kind of securities, cash or property, as they would have been entitled to receive upon the occurrence of the merger if they had been, immediately prior to the merger, the holders of the number of warrant shares then issuable upon exercise in full of these warrants.

For a more complete discussion of the treatment of SYS Subordinated Convertible Notes and Warrants, see "The Merger Subordinated Convertible Notes" and "The Merger Warrants," each beginning on page 68.

Treatment of Stock Options and Other Stock-Based Awards

All outstanding SYS stock options will become fully vested and exercisable into SYS shares at or prior to closing in accordance with the terms of their respective stock option plans and may be subject to withholding taxes as a result. No SYS stock options will be assumed by or converted into options of Kratos.

Effective February 20, 2008, the execution date of the merger agreement, SYS terminated the then current stock purchase period for its Employee Stock Purchase Plan, and Kratos is not assuming this plan.

For a more complete discussion of the treatment of SYS options and other stock-based awards, see "The Merger Agreement Treatment of SYS Options" beginning on page 80.

Directors and Executive Management Following the Merger

The directors and executive management of Kratos will remain unchanged at the effective time of the merger.

At the effective time of the merger, the directors and officers of Merger Sub will become the directors and officers of SYS until each is replaced by his or her successor.

For a more complete discussion of the directors and management of Kratos, see "The Merger Composition of Kratos Board of Directors" beginning on page 66.

Recommendations of the Kratos Board of Directors

After careful consideration, the Kratos board of directors unanimously recommends that holders of Kratos common stock vote **FOR** the issuance of Kratos common stock in connection with the merger.

For a more complete description of the Kratos reasons for the merger and the recommendations of the Kratos board of directors, see "The Merger The Kratos Board of Directors Recommendations and Reasons for the Merger" beginning on page 49.

Recommendation of the SYS Board of Directors

After careful consideration, the SYS board of directors unanimously recommends that holders of SYS common stock vote **FOR** the Merger Proposal.

For a more complete description of SYS's reasons for the merger and the recommendation of the SYS board of directors, see "The Merger The SYS Board of Directors' Recommendation and Reasons for the Merger" beginning on page 51.

Opinions of Financial Advisors

Kratos Financial Advisor

Wachovia Capital Markets, LLC, which we refer to as Wachovia, delivered an opinion to Kratos' board of directors that, subject to and based upon the assumptions made, procedures followed, matters considered and limitations on its review undertaken, as of February 20, 2008, the exchange ratio in the merger agreement was fair from a financial point of view to Kratos. The full text of Wachovia's written opinion, dated February 20, 2008, is attached as *Annex D* to this Proxy Statement. Holders of shares of Kratos common stock are urged to read the opinion carefully and in its entirety. Wachovia's opinion does not and shall not constitute a recommendation to any holders of shares of Kratos common stock as to how they should vote in connection with the Merger. This summary of Wachovia's opinion contained in this Proxy Statement is qualified in its entirety by reference to the full text of the opinion.

For a more complete description of Wachovia's opinion, see "The Merger Opinion of Financial Advisor to the Kratos Board of Directors" beginning on page 53. See also *Annex D* to this Proxy Statement.

SYS Financial Advisor

Imperial Capital, LLC, which is referred to as Imperial Capital, has rendered its opinion to the SYS board of directors to the effect that, as of February 19, 2008, and based upon and subject to the factors, assumptions, qualifications and limitations set forth therein, the exchange ratio of 1.2582 shares of Kratos common stock to be received for each share of SYS common stock pursuant to the merger agreement was fair from a financial point of view to the holders of such shares of SYS common stock.

The full text of the written opinion of Imperial Capital, dated February 19, 2008, is attached as *Annex E* to this Proxy Statement and sets forth assumptions made, general procedures followed, factors considered and limitations and qualifications on the review undertaken by Imperial in connection with its opinion. Imperial Capital provided its opinion for the information and assistance of the SYS board of directors in connection with its consideration of the merger. The Imperial Capital opinion is not a recommendation as to how any holder of shares of SYS common stock should vote with respect to the merger.

For a more complete description of the Imperial Capital opinion and engagement letter, see "The Merger Opinion of Financial Advisor to the SYS Board of Directors" beginning on page 59. See also *Annex E* to this Proxy Statement.

Interests of SYS Directors and Executive Officers in the Merger

When you consider the unanimous recommendation of SYS's board of directors that SYS shareholders approve the merger agreement, the plan of merger and the merger, you should be aware that some SYS officers and directors may have interests in the transaction that may be different from, or in addition, to their interests as shareholders of SYS.

For a further discussion of interests of directors and executive officers in the merger, see "The Merger Interests of SYS Directors and Executive Officers in the Merger" beginning on page 66.

Material United States Federal Income Tax Consequences of the Merger

Kratos and SYS intend for the merger to qualify as a reorganization within the meaning of Section 368(a) of the Code for U.S. federal income tax purposes. Accordingly, SYS shareholders generally will not recognize gain or loss for U.S. federal income tax purposes upon the receipt of Kratos common stock in the merger, except that an SYS shareholder will recognize gain or loss with respect to any cash received in lieu of a fractional share of Kratos common stock. It is a condition to completion of the merger that Kratos and SYS each receive a legal opinion from their respective counsel that the merger will constitute a reorganization within the meaning of Section 368 of the Code In the event that such counsel does not render this opinion, this condition shall be deemed to be satisfied if the other party's counsel delivers the opinion to both Kratos and SYS.

Tax matters are very complicated and the tax consequences of the merger to you, if you are an SYS shareholder, will depend upon the facts of your situation. In addition, you may be subject to state, local or foreign tax laws that are not addressed in this Proxy Statement. You are urged to consult with your own tax advisors for a full understanding of the tax consequences of the merger to you.

For a more complete description of the material U.S. federal income tax consequences of the merger, see "Material United States Federal Income Tax Consequences" beginning on page 76.

Accounting Treatment of the Merger

The merger will be accounted for as an acquisition by Kratos of SYS under the purchase method of accounting according to U.S. generally accepted accounting principles.

Dissenters' Rights and Appraisal Rights

Under applicable law:

- Kratos stockholders have no dissenters' or appraisal rights with respect to the merger under Section 262 of Delaware General Corporate Law; and

- SYS shareholders are entitled to dissenters' rights under the California General Corporation Law in connection with the merger if the specific conditions set forth in the section entitled "The Merger Dissenters' Rights and Appraisal Rights," which begins on page 71, are met.

Conditions to Completion of the Merger

Kratos and SYS expect to complete the merger after all the conditions to the merger in the merger agreement are satisfied or waived, including after the receipt of stockholder approvals at the annual meeting of Kratos and at the special meetings of SYS. Kratos and SYS currently expect to complete the merger during the first half of 2008. However, it is possible that factors outside of either company's control could cause the merger to be competed at a later time or not at all.

Each party's obligation to complete the merger is subject to the satisfaction or waiver of various conditions, including the following:

- the receipt of the required stockholder approvals;

- the effectiveness of the registration statement of which this Proxy Statement is a part, and the registration statement not being subject to any stop order or threatened stop order;

- the absence of any injunctions or legal prohibitions preventing the consummation of the merger;

- the receipt of opinions of counsel relating to the U.S. federal income tax treatment of the merger;

- the accuracy of the other party's representations and warranties in the merger agreement, including the other party's representation that no material adverse effect has occurred;

- the other party's compliance in all material respects with its obligations under the merger agreement; and

- the receipt of authorization from The Nasdaq Global Select Stock Market for listing of Kratos common stock to be issued in connection with the merger.

Neither Kratos nor SYS is aware of the need to obtain any other material regulatory approvals in order to complete the merger.

The merger agreement provides that certain of these conditions may be waived, in whole or in part, by Kratos or SYS, to the extent legally allowed. Neither Kratos nor SYS currently expects to waive any material condition to the completion of the merger. If either Kratos or SYS determines to waive any condition to the merger that would result in a material and adverse change in the terms of the merger to Kratos or SYS shareholders (including any change in the tax consequences of the transaction to SYS shareholders), proxies would be resolicited from the Kratos or SYS shareholders, as applicable.

For a more complete discussion of the conditions to the merger, see "The Merger Agreement Conditions to Completion of the Merger" beginning on page 84.

Timing of the Merger

The merger is expected to be completed during the first half of 2008, subject to the receipt of necessary regulatory approvals and the satisfaction or waiver of other closing conditions. For a discussion of the timing of the merger, see "The Merger Agreement Closing and Effective Time of the Merger" beginning on page 79.

No Solicitation of Other Offers

In the merger agreement, SYS has agreed that it will not directly or indirectly:

- solicit, initiate, or knowingly or intentionally encourage or facilitate, any inquiries, offers or proposals that constitute, or could reasonably be expected to lead to, any alternative acquisition proposal; or
- enter into, continue or otherwise participate in any discussions or negotiations regarding, furnish to any person any non-public information with respect to, assist or participate in any effort or attempt by any person with respect to, or otherwise knowingly or intentionally cooperate in any way with, any alternative acquisition.

The merger agreement does not, however, prohibit SYS from considering a bona fide acquisition proposal from a third party if certain specified conditions are met.

For a discussion of the prohibition on solicitation of acquisition proposals from third parties, see "The Merger Agreement No Solicitation; Changes in Recommendations" beginning on page 85.

Termination

Generally, the merger agreement may be terminated and the merger may be abandoned at any time prior to the completion of the merger (including after stockholder approval):

- by mutual written consent of Kratos and SYS;
- by either Kratos or SYS, if
  - the merger is not consummated on or before August 20, 2008; except that such right is not available to any party whose failure to comply with the merger agreement has been a principal cause of, or resulted in, the merger not being consummated by such date and provided that this date (referred to herein as the "outside date") may be extended to February 20, 2009 by either Kratos or SYS;
  - a governmental entity issues an order, decree or ruling or takes any other nonappealable final action permanently restraining, enjoining or otherwise prohibiting the merger;

- the required Kratos or SYS shareholder vote has not been obtained at the applicable stockholder meeting or any adjournment or postponement thereof (except that this right is not available to any party who is in material breach of or has materially failed to fulfill its obligations under the merger agreement);

- the SYS board of directors changes its recommendation that its shareholders vote in favor of the merger proposal, or if SYS enters into an acquisition agreement relating to an alternative transaction; or

- the other party breaches any of its agreements or representations in the merger agreement in such a way as would cause one or more of the conditions to closing not to be satisfied, and such breach is either incurable or is not cured after 30 days' written notice;

by Kratos, if:

- SYS willfully and materially breaches its covenants with respect to non-solicitation of an alternative acquisition proposal or its obligations to hold its shareholders meeting and mail this Proxy Statement to its shareholders; or

- SYS's board of directors determines to accept an alternative acquisition proposal for a change of control transaction, in which case SYS would be required to pay the applicable termination fee (as described below); or

by SYS to accept a proposal from a third party to acquire SYS that SYS's board of directors determines to be superior to the terms of Kratos' proposed acquisition of SYS, if SYS's board of directors changes or withdraws its recommendation of the merger in response to such superior proposal and pays the applicable termination fee (as described below).

Termination Fees and Expenses

Pursuant to the merger agreement, SYS is required to pay a termination fee of $2,394,000 dollars to Kratos in the event the merger agreement is terminated:

By Kratos, if

- the SYS board of directors has failed to reconfirm its recommendation of approval of the SYS voting proposal after Kratos requests such reconfirmation pursuant to the terms of the merger agreement;

- the SYS board of directors or any committee of the SYS board of directors has approved or recommended to the SYS shareholders an alternative acquisition transaction;

- SYS enters into an alternative acquisition transaction; or

- SYS has willfully breached its obligations under the merger agreement pertaining to non-solicitation of alternative acquisition proposals and the SYS shareholder meeting to approve the SYS Voting Agreement.

By SYS, if its board of directors or any committee thereof has made a recommendation to accept an alternative transaction proposal and SYS enters into an alternative acquisition agreement which was the subject of such adverse recommendation change.

Whether or not the merger is completed, all costs and expenses incurred in connection with the merger agreement and the transactions contemplated by the merger agreement will be paid by the party incurring those costs or expenses, except that Kratos and SYS will share equally the expenses incurred in connection with the printing and mailing of this Proxy Statement.

This termination fee could discourage other companies from seeking to acquire or merge with either SYS or Kratos. See "The Merger Agreement Termination," " Termination Fees and Expenses" and " Effect of Termination," beginning on pages 86, 87 and 88, respectively.

Comparison of the rights of Kratos and SYS shareholders

The rights of SYS shareholders as Kratos stockholders after the merger will be governed by Kratos' certificate of incorporation and bylaws, each as amended, and the laws of the State of Delaware. Those rights differ from the rights of SYS shareholders under SYS's articles of incorporation and bylaws and the laws of the State of California.

Matters to be Considered at the Meetings

Kratos

Kratos stockholders will be asked to vote on the following six proposals:

1. To elect five directors for one-year terms or until their successors are elected and duly qualified.

2. To ratify the selection of Grant Thornton LLP as the independent auditors of Kratos for the fiscal year ending December 28, 2008.

3. To approve an amendment to the Kratos 1999 Employee Stock Purchase Plan to increase the aggregate number of shares that may be issued under the Plan by 1,500,000 shares.

4. To approve an amendment to the Kratos 2005 Equity Incentive Plan to increase the aggregate number of shares that may be issued under the Plan by 3,000,000 shares.

5. To approve the issuance of Kratos common stock, par value $0.001 per share, pursuant to the Agreement and Plan of Merger and Reorganization, dated as of February 20, 2008, by and among Kratos Defense & Security Solutions, Inc., White Shadow, Inc., and SYS, as the same may be amended from time to time.

6. To approve any motion to adjourn or postpone the annual meeting to a later date or dates, if necessary, to solicit additional proxies if there are insufficient votes at the time of the annual meeting to approve the first five proposals listed above.

7. To transact such other business as may properly come before the annual meeting or any adjournment or postponement thereof.

The Kratos board of directors unanimously recommends that Kratos stockholders vote FOR all of the proposals set forth above, as more fully described under "Kratos Annual Meeting" beginning on page 155.

SYS

SYS shareholders will be asked to vote on the following two proposals:

1. To adopt and approve the Agreement and Plan of Merger and Reorganization.

2. To approve any motion to adjourn or postpone the special meeting to a later date or dates, if necessary, to solicit additional proxies if there are insufficient votes at the time of the special meeting to approve the proposal to adopt the merger agreement.

3. To transact such other business as may properly come before the special meeting or any adjournment or postponement thereof.

The SYS board of directors unanimously recommends that SYS shareholders vote FOR all of the proposals set forth above, as more fully described under "SYS Special Meeting" beginning on page 206.

Voting by Kratos and SYS Directors and Executive Officers

On May 19, 2008, the record date set by the Kratos board of directors, directors and executive officers of Kratos and their affiliates owned and were entitled to vote 7,190,308 shares of Kratos common stock, or approximately 9.0%, of the total voting power of the shares of Kratos common stock outstanding on that date.

On May 15, 2008, the record date set by the SYS board of directors, directors and executive officers of SYS and their affiliates owned and were entitled to vote 4,190,373 shares of SYS common stock, or approximately 21.1% of the shares of SYS common stock outstanding on that date. Stockholders of SYS holding approximately 7.4% of the shares of SYS common stock outstanding on that date have executed voting agreements agreeing to vote in favor of the merger.

SELECTED HISTORICAL FINANCIAL DATA OF KRATOS

The tables below present summary selected consolidated historical financial data of KRATOS *(in millions except for per share data)* prepared in accordance with accounting principles generally accepted in the United States of America. This information should be read in conjunction with "INFORMATION RELATING TO KRATOS KRATOS MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS," "INFORMATION RELATING TO KRATOS BUSINESS" and Kratos' consolidated financial statements and related notes, included elsewhere in this proxy statement/prospectus.

	Year Ended December 31, (in millions)					Three Months Ended	
	2003	2004	2005	2006	2007	March 31, 2007	March 30, 2008
						Unaudited	
CONSOLIDATED STATEMENT OF OPERATIONS DATA:							
Revenues	$ 43.4	$ 116.9	$ 152.3	$ 153.1	$ 193.6	$ 49.0	$ 68.2
Operating costs and expenses:							
Costs of revenues	22.2	87.9	115.7	124.2	162.0	41.7	55.6
Selling, general and administrative expenses	18.0	28.9	35.5	38.5	39.5	9.1	11.9
Stock option investigation and related fees					14.0	1.5	
Estimated cost for settlement of securities litigation					4.9		
Loss (recovery) of unauthorized issuance of stock options	5.7				(3.4)		
Contingent acquisition consideration and restatement fees		13.9	(2.1)	0.1			
Impairment and restructuring fees	0.1			21.8	1.2		
Total operating costs and expenses	46.0	130.7	149.1	184.6	218.2	52.3	67.5
Operating income (loss) from continuing operations	(2.6)	(13.8)	3.2	(31.5)	(24.6)	(3.3)	0.7
Other (income) expense:							
Interest income (expense), net	0.9	0.2	0.1	(0.7)	(1.2)		(2.3)
Impairment of investments in unconsolidated subsidiaries		(2.9)			(1.8)		
Other income and (expense), net	(0.1)	(0.1)	0.2	(0.2)	0.7	0.5	(0.4)
Total other (income) expense	0.8	(2.8)	0.3	(0.9)	(2.3)	0.5	(2.7)
Income (loss) from continuing operations before income taxes	(1.8)	(16.6)	3.5	(32.4)	(26.9)	(2.8)	(2.0)
Provision (benefit) for income taxes from continuing operations	(1.0)	(8.4)	(0.1)	13.8	1.3	0.2	0.5
Income (loss) from continuing operations	(0.8)	(8.2)	3.6	(46.2)	(28.2)	(3.0)	(2.5)
Income (loss) from discontinued operations	2.7	23.2	(2.0)	(11.7)	(12.6)	(17.1)	0.6
Net income (loss)	$ 1.9	$ 15.0	$ 1.6	$ (57.9)	$ (40.8)	$ (20.1)	$ (1.9)
Basic earnings (loss) per common share:							
Continuing operations	$ (0.01)	$ (0.12)	$ 0.05	$ (0.63)	$ (0.38)	$ (0.04)	$ (0.03)
Discontinued operations	0.04	0.34	(0.03)	(0.16)	(0.17)	(0.23)	0.01
Net income (loss)	$ 0.03	$ 0.22	$ 0.02	$ (0.79)	$ (0.55)	$ (0.27)	$ (0.02)

							Three Months Ended
Diluted earnings (loss) per common share:							
Continuing operations	$ (0.01)	$ (0.12)	$ 0.05	$ (0.63)	$ (0.38)	$ (0.04)	$ (0.03)
Discontinued operations	0.04	0.34	(0.03)	(0.16)	(0.17)	(0.23)	0.01
Net income (loss)	$ 0.03	$ 0.22	$ 0.02	$ (0.79)	$ (0.55)	$ (0.27)	$ (0.02)
Weighted average common shares outstanding:							
Basic	68.4	67.7	74.0	73.5	74.0	73.9	79.0
Diluted	68.4	67.7	75.0	73.5	74.0	73.9	79.0

	December 31, (in millions)					March 30, (in millions)
	2003	2004	2005	2006	2007	2008
						(unaudited)
CONSOLIDATED BALANCE SHEET DATA:						
Cash and cash equivalents	$ 75.8	$ 58.0	$ 7.7	$ 5.4	$ 8.6	$ 11.0
Working capital	132.5	98.6	67.4	(3.8)	23.4	24.5
Goodwill	5.5	57.1	94.4	129.9	194.5	196.7
Other intangible assets	1.9	6.4	7.4	13.4	19.9	18.7
Total assets	279.3	330.7	342.0	337.7	335.3	334.1
Total debt	0.7	1.9	0.7	51.4	76.7	78.8
Stockholders' equity	$ 191.9	$ 219.6	$ 229.7	$ 187.1	$ 167.2	$ 167.2

SELECTED HISTORICAL FINANCIAL DATA OF SYS

The tables below present summary selected consolidated historical financial data of SYS *(in millions except for per share data)* prepared in accordance with accounting principles generally accepted in the United States of America. This information should be read in conjunction with "INFORMATION RELATING TO SYS SYS MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS," "INFORMATION RELATING TO SYS BUSINESS" and SYS's consolidated financial statements and related notes, included elsewhere in this proxy statement/prospectus.

The statement of operations data for the nine months ended March 28, 2008 and March 30, 2007, and the balance sheet data as of March 28, 2008 are unaudited but include, in the opinion of management of SYS, all adjustments including normal recurring adjustments, necessary for a fair presentation of such information. Results for the nine months ended March 28, 2008 and March 30, 2007 are not necessarily indicative of the results that may be expected for any other interim periods or for the fiscal year as a whole.

	Year Ended June 30,					Nine Months Ended	
	2003	2004	2005	2006	2007	March 30, 2007	March 28, 2008
	(In millions)					(Unaudited)	
CONSOLIDATED STATEMENT OF OPERATIONS DATA:							
Revenues	$ 24.8	$ 34.9	$ 45.8	$ 55.9	$ 75.8	$ 54.5	$ 57.3
Operating costs and expenses:							
Costs of revenues	20.6	28.8	37.4	44.6	58.0	42.0	41.8
Selling, general and administrative expenses	3.5	4.1	4.9	8.5	15.5	11.0	10.1
Research, engineering and development expenses			0.7	3.6	4.0	3.0	3.2
Merger transaction costs							0.5
Legal settlement	1.0						
Impairment charges				1.3			
Total operating costs and expenses	25.1	32.9	43.0	58.0	77.5	56.0	55.6
Income (loss) from operations	(0.3)	2.0	2.8	(2.1)	(1.7)	(1.5)	1.7
Other (income) expense:							
Other income		(0.1)	(0.1)	(0.2)	(0.1)	(0.1)	(0.1)
Interest expense	0.2	0.3	0.5	0.5	0.8	0.5	0.3
Total other income	0.2	0.2	0.4	0.3	0.7	0.4	0.2
Income (loss) from continuing operations before income taxes	(0.5)	1.8	2.4	(2.4)	(2.4)	(1.9)	1.5
Income tax (benefit) provision	(0.2)	0.8	1.0	(0.7)	(0.7)	(0.4)	0.9
Income (loss) from continuing operations	(0.3)	1.0	1.4	(1.7)	(1.7)	(1.5)	0.6
Loss from discontinued operations, net of taxes	(0.5)						
Net income (loss)	(0.8)	1.0	1.4	(1.7)	(1.7)	(1.5)	0.6
Net income (loss) applicable to common stock	$ (0.8)	$ 1.0	$ 1.4	(1.7)	(1.7)	(1.5)	$ 0.6
Basic earnings (loss) per common share:							
Continuing operations	$ (0.06)	$ 0.15	$ 0.16	$ (0.14)	$ (0.10)	$ (0.09)	$ 0.03
Discontinued operations	(0.09)						

						Nine Months Ended	
Net income (loss)	$ (0.15)	$ 0.15	$ 0.16	$ (0.14)	$ (0.10)	$ (0.09)	$ 0.03
Diluted earnings (loss) per common share:							
Continuing operations	$ (0.06)	$ 0.13	$ 0.15	$ (0.14)	$ (0.10)	$ (0.09)	$ 0.03
Discontinued operations	(0.09)						
Net income (loss)	$ (0.15)	$ 0.13	$ 0.15	$ (0.14)	$ (0.10)	$ (0.09)	$ 0.03
Weighted average common shares outstanding:							
Basic	5.2	6.7	8.7	12.7	17.6	17.2	19.5
Diluted	5.2	8.5	11.2	12.7	17.6	17.2	19.6

	June 30,					March 28, 2008
	2003	2004	2005	2006	2007	(Unaudited)
CONSOLIDATED BALANCE SHEET DATA:						
Cash and cash equivalents	$	$ 2.2	$ 3.5	$ 2.1	$ 2.8	$ 1.6
Working capital	3.2	5.2	8.1	7.3	8.2	8.1
Goodwill		5.5	7.3	18.6	23.5	23.1
Other intangible assets		0.6	1.2	3.4	6.1	5.3
Total assets	7.7	17.7	24.8	42.2	52.4	50.4
Total debt	1.2	3.6	2.4	3.9	3.6	3.6
Preference stock	0.1					
Stockholders' equity	3.1	8.3	15.4	27.5	35.1	37.1

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SUMMARY UNAUDITED PRO FORMA CONDENSED COMBINED FINANCIAL DATA

The following summary unaudited pro forma condensed combined financial information is designed to show how the merger of Kratos and SYS might have affected historical financial statements if the merger had been completed at an earlier time and was prepared based on the historical financial results reported by Kratos, including Haverstick, and SYS. The following should be read in connection with "Unaudited Pro Forma Condensed Combined Financial Statements" beginning on page 210 and the Kratos, SYS and Haverstick audited consolidated financial statements beginning on pages FI-1, FII-1 and FIII-1, respectively.

The pro forma condensed combined financial data is presented for illustrative purposes only and is not necessarily indicative of the financial condition or results of operations of future periods or the financial condition or results of operations that actually would have been realized had the entities been a single company during these periods.

	Year Ended December 31, 2007	Period Ended March 30, 2008
	(In millions, except per share amounts)	(In millions, except per share amounts)
Statements of Operations Data:		
Revenues	$ 366.8	$ 86.9
Operating income (loss)	(20.6)	1.2
Net loss from continuing operations	$ (34.0)	$ (2.3)
Loss per common share:		
Basic	$ (0.33)	$ (0.02)
Diluted	$ (0.33)	$ (0.02)
Weighted average common shares outstanding:		
Basic	104.6	104.3
Diluted	104.6	104.3

	As of March 30, 2008
Balance Sheet Data:	
Cash and cash equivalents	$ 6.1
Property and equipment, net	8.6
Goodwill	237.2
Intangible assets, net	26.4
Total assets	397.3
Long-term debt, net of current portion	76.1
Accumulated deficit	(247.4)
Total stockholders' equity	218.3

COMPARATIVE PER SHARE DATA (UNAUDITED)

The following table shows per share data regarding losses from continuing operations, book value and cash dividends for Kratos, including Haverstick, and SYS on a historical, pro forma combined basis. The pro forma book value per share information was computed as if the merger had been completed on December 31, 2007. The pro forma losses from continuing operations information was computed as if the merger had been completed on January 1, 2007. The SYS pro forma equivalent information was calculated by multiplying the corresponding pro forma combined data by the exchange ratio of 1.2582. This information shows how each share of SYS common stock would have participated in the combined companies' losses from continuing operations and book value per share if the merger had been completed on the relevant dates. These amounts do not necessarily reflect future per share amounts of earnings (losses) from continuing operations and book value per share of Kratos.

The following unaudited comparative per share data is derived from the historical consolidated financial statements of each of Kratos and SYS. The information below should be read in conjunction with the audited consolidated financial statements and accompanying notes of Kratos, SYS and Haverstick, which are included in this Proxy Statement. We urge you also to read "Unaudited Pro Forma Condensed Combined Financial Statements" beginning on page 210.

	As of and for the year ended December 31, 2007	As of and for the three month period ended March 30, 2008
Kratos Historical		
Basic loss per share	$ (0.38)	$ (0.03)
Diluted loss per share	$ (0.38)	$ (0.03)
Book value per common share	$ 2.26	$ 2.12
Cash dividends per share	$	$
SYS Historical		
Basic loss per share	$ (0.04)	$ (0.00)
Diluted loss per sharee	$ (0.04)	$ (0.00)
Book value per common share	$ 1.89	$ 1.87
Cash dividends per share	$	$
Unaudited Pro Forma Combined		
Basic loss per share	$ (0.33)	$ (0.02)
Diluted loss per share	$ (0.33)	$ (0.02)
Book value per common share	$ 2.09	$ 2.09
Cash dividends per share	$	$
Unaudited Pro Forma Combined SYS Equivalents(1)		
Basic loss per share	$ (0.41)	$ (0.03)
Diluted loss per share	$ (0.41)	$ (0.03)
Book value per common share	$ 2.64	$ 2.63
Cash dividends per share	$	$

(1) SYS pro forma equivalent amounts are calculated by multiplying pro forma per share amounts by the exchange ratio of 1.2582.

MARKET PRICES AND DIVIDENDS AND OTHER DISTRIBUTIONS

Kratos

Since November 4, 1999, the Common Stock of Kratos has been traded on the Nasdaq Global Stock Exchange under the symbols "WFII" and "KTOS." The ranges of high and low quotations during the two most recent fiscal years of Kratos are as follows:

	High	Low
Fiscal Year 2008		
First Quarter	$ 2.35	$ 1.50
Second Quarter through May 19, 2008	$ 1.87	$ 1.57
Fiscal Year 2007		
First Quarter	$ 2.94	$ 1.20
Second Quarter	$ 1.80	$ 1.01
Third Quarter	$ 2.85	$ 1.70
Fourth Quarter	$ 3.09	$ 1.80
Fiscal Year 2006		
First Quarter	$ 5.56	$ 3.73
Second Quarter	$ 4.53	$ 2.75
Third Quarter	$ 2.94	$ 1.85
Fourth Quarter	$ 2.98	$ 1.98

This summary is based on prices quoted by the Nasdaq Global Stock Exchange.

As of May 19, 2008, there were approximately 217 holders of record of the Common Stock of Kratos.

No cash dividends have been paid on Kratos Common Stock during the two most recent fiscal years of Kratos, and Kratos does not intend to pay cash dividends on its Common Stock in the immediate future.

SYS

Since January 3, 2005, the Common Stock of SYS has been traded on the American Stock Exchange under the symbol "SYS." Prior to that date, SYS Common Stock was traded in the over-the-counter market. The ranges of high and low quotations during SYS's two most recent fiscal years are as follows:

	High	Low
Fiscal Year 2008		
First Quarter	$ 2.52	$ 1.90
Second Quarter	$ 2.45	$ 1.60
Third Quarter	$ 2.47	$ 1.30
Fourth Quarter through May 16, 2008	$ 2.20	$ 1.80
Fiscal Year 2007		
First Quarter	$ 2.90	$ 2.10
Second Quarter	$ 3.14	$ 2.11
Third Quarter	$ 2.80	$ 1.97
Fourth Quarter	$ 2.34	$ 1.73
Fiscal Year 2006		
First Quarter	$ 4.33	$ 2.61
Second Quarter	$ 5.98	$ 3.34
Third Quarter	$ 4.25	$ 3.35
Fourth Quarter	$ 3.95	$ 2.70

This summary is based on prices quoted by the American Stock Exchange.

As of May 16, 2008, there were approximately 697 holders of record of SYS's Common Stock.

No cash dividends have been paid on SYS Common Stock during the two most recent fiscal years of SYS, and SYS does not intend to pay cash dividends on its Common Stock in the immediate future.

REFERENCES TO ADDITIONAL INFORMATION

This Proxy Statement incorporates important business and financial information about Kratos from documents filed with the Securities and Exchange Commission that have not been included in or delivered with this document. This information is available at the internet website that the Securities and Exchange Commission maintains at http://www.sec.gov, as well as from other sources.

You may also request copies of these documents from Kratos, without charge, upon written or oral request to:

Kratos Defense & Security Solutions, Inc.
4810 Eastgate Mall
San Diego, California 92121
Attn: Investor Relations
(858) 812-7300

In order to receive timely delivery of the documents, you must make your request no later than June 15, 2008.

For more information, see the section entitled "Where You Can Find More Information."

CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING STATEMENTS

We make forward-looking statements in this Proxy Statement. These forward-looking statements relate to outlooks or expectations for earnings, revenues, expenses, asset quality or other future financial or business performance, strategies or expectations, or the impact of legal, regulatory or supervisory matters on business, results of operations or financial condition. Specifically, forward looking statements may include:

- statements relating to the benefits of the merger, including anticipated synergies and cost savings estimated to result from the merger;
- statements relating to future business prospects, revenue, income and financial condition; and
- statements preceded by, followed by or that include the words "estimate," "plan," "project," "forecast," "intend," "expect," "anticipate," "believe," "seek," "target" or similar expressions.

These statements reflect management judgments based on currently available information and involve a number of risks and uncertainties that could cause actual results to differ materially from those in the forward-looking statements.

Future performance cannot be ensured. Actual results may differ materially from those in the forward-looking statements. Some factors that could cause actual results to differ include:

- the ability to obtain governmental approvals of the merger on the proposed terms and time schedule, and without the imposition of significant terms, conditions, obligations or restrictions;
- the risk that the businesses will not be integrated successfully;
- expected cost savings from the merger may not be fully realized within the expected time frames or at all;
- revenues following the merger may be lower than expected;
- the effects of vigorous competition in the markets in which Kratos and SYS operate;
- the possibility of one or more of the markets in which Kratos and SYS compete being impacted by changes in political or other factors such as monetary policy, legal and regulatory changes or other external factors over which they have no control;
- the ability of Kratos to obtain debt financing on terms favorable to it or at all, whether to complete any required refinancing of outstanding debt or otherwise;
- changes in general economic and market conditions; and
- other risks referenced from time to time in filings with the SEC and those factors listed in this Proxy Statement under "Risk Factors" beginning on page 24.

You are cautioned not to place undue reliance on any forward-looking statements, which speak only as of the date of this Proxy Statement, or in the case of any other document, as of the date of that document. Except as required by law, neither Kratos nor SYS undertakes any obligation to publicly update or release any revisions to these forward-looking statements to reflect any events or circumstances after the date hereof or to reflect the occurrence of unanticipated events.

Additional factors that could cause actual results to differ materially from those expressed in the forward-looking statements are discussed in this Prospectus, including the section of this Prospectus entitled "Risk Factors."

RISK FACTORS

In addition to the other information contained in this Proxy Statement, you should carefully consider the following risk factors in deciding how to vote on the merger. In addition, you should read and consider the risks associated with each of the businesses of Kratos and SYS because these risks will also relate to Kratos following completion of the merger.

The failure to successfully integrate SYS's business and operations in the expected time frame may adversely affect the combined company's future results.

Kratos believes that the merger with SYS will result in certain benefits including cost synergies and operational efficiencies. To realize the anticipated benefits, Kratos will be required to devote significant management attention and resources to integrating the two companies. The merger involves the integration of two companies that have previously operated independently with principal offices in two distinct locations. Due to legal restrictions, at present Kratos and SYS are able to conduct only limited planning regarding the integration of the two companies. The actual integration may result in additional and unforeseen expenses or delays. If Kratos is not able to successfully integrate SYS' business and operations, or if there are delays in combining the businesses, the anticipated benefits of the merger may not be realized fully or at all or may take longer to realize than expected. Failure to realize the full benefits of the merger could adversely affect Kratos' business, financial results, financial condition and stock price following the merger.

Because the market price of Kratos common stock will fluctuate, SYS shareholders cannot be sure of the market value of the Kratos common stock that they will receive.

When we complete the merger, each share of SYS common stock will be converted into the right to receive 1.2582 shares of Kratos common stock. The exchange ratio is fixed and will not be adjusted for changes in the market price of either Kratos common stock or SYS common stock. The merger agreement does not provide for any price-based termination right for either party. Accordingly, the market value of the shares of Kratos common stock that Kratos issues and SYS shareholders will be entitled to receive when the parties complete the merger will depend on the market value of shares of Kratos common stock at the time that the parties complete the merger and could vary significantly from the market value on the date of this Proxy Statement or the date of the Kratos annual meeting and the SYS special meeting. The market value of Kratos common stock will continue to fluctuate after the completion of the merger. For example, during the third and the fourth calendar quarters of 2007, the sales price of Kratos common stock ranged from a low of $1.70 to a high of $3.09, all as reported on The Nasdaq Global Select Stock Market. See "Market Prices and Dividends and Other Distributions" on page 21.

These variations could result from changes in the business, operations or prospects of Kratos or SYS prior to or following the merger, market assessments as to whether and when the merger will be consummated, regulatory considerations, general market and economic conditions and other factors both within and beyond the control of Kratos or SYS.

The issuance of shares of Kratos common stock to SYS shareholders in the merger will substantially dilute the interest in Kratos held by Kratos stockholders prior to the merger.

If the merger is completed, Kratos will issue up to approximately 25.3 million shares of Kratos common stock in the merger. Based on the number of shares of Kratos and SYS common stock outstanding on the Kratos and SYS record dates, SYS shareholders before the merger will own, in the aggregate, approximately 24% of the shares of Kratos common stock outstanding immediately after the merger on a fully diluted basis. The issuance of shares of Kratos common stock to SYS shareholders in the merger will cause a significant reduction in the relative percentage interest of current Kratos stockholders in the earnings, voting rights, liquidation value and book and market value of Kratos.

Uncertainty about the merger and diversion of management could harm Kratos and SYS, whether or not the merger is completed.

In response to the announcement of the merger, existing or prospective customers of Kratos or SYS may delay or defer their procurement or other decisions concerning Kratos or SYS, or they may seek to change their existing business relationship. In addition, as a result of the merger, current and prospective employees could experience uncertainty about their future with Kratos or SYS, and either organization could lose key employees as a result. In addition to retention, these uncertainties may also impair each company's ability to recruit or motivate key personnel. Completion of the merger will also require a significant amount of time and attention from management. The diversion of management attention away from ongoing operations could adversely affect ongoing operations and business relationships.

Failure to complete the merger could adversely affect Kratos' and SYS's stock prices and their future business and financial results.

Completion of the merger is conditioned upon, among other things, the receipt of approval of the Kratos and SYS stockholders. There is no assurance that the parties will receive the necessary approvals or satisfy the other conditions to the completion of the merger. Failure to complete the proposed merger would prevent Kratos and SYS from realizing the anticipated benefits of the merger. Each company will also remain liable for significant transaction costs, including legal, accounting and financial advisory fees. In addition, the market price of each company's common stock may reflect various market assumptions as to whether the merger will occur. Consequently, the failure to complete the merger could result in a significant change in the market price of the common stock of Kratos and SYS.

The combined company will incur significant transaction and merger-related costs in connection with the merger.

Kratos and SYS expect to incur significant costs associated with completing the merger and combining the operations of the two companies. The exact magnitude of these costs is not yet known. In addition, there may be unanticipated costs associated with the integration. Although Kratos and SYS expect that the elimination of duplicative costs and other efficiencies may offset incremental transaction and merger-related costs over time, these benefits may not be achieved in the near term or at all.

Because SYS's executive officers have interests in seeing the merger completed that are different than those of SYS's other shareholders, these persons may have conflicts of interest in recommending that SYS shareholders vote to adopt and approve the merger agreement.

Certain of SYS's directors and executive officers have interests in the merger that are different from, or are in addition to, the interests of SYS shareholders generally. This difference of interests stems from the equity and equity-linked securities held by such persons, the change of control severance arrangements covering SYS's executive officers under which such officers are entitled to severance payments and other benefits if their employment is terminated following the merger, and the Kratos obligation under the merger agreement to indemnify SYS's directors and officers following the merger. These and other material interests of the directors and executive officers of SYS in the merger that are different than those of the other SYS shareholders are described under "The Merger Interests of SYS Directors and Executive Officers" beginning on page 66.

The merger agreement contains provisions that could discourage a potential alternative acquirer that might be willing to pay more to acquire SYS.

The merger agreement contains "no shop" provisions that restrict SYS's ability to solicit or facilitate proposals regarding a merger or similar transaction with another party. Further, there are only limited exceptions to SYS's agreement that its board of directors will not withdraw or adversely qualify its recommendation regarding the merger agreement. SYS's board of directors is permitted to terminate the merger agreement in response to an unsolicited third party proposal to acquire SYS, which SYS's board of directors determines to be more favorable than the merger with Kratos. However, if SYS or Kratos terminates the merger agreement because SYS has received an acquisition proposal that is deemed more favorable by its board of directors, Kratos will be entitled to collect a $2,394,000 termination fee from SYS. We describe these provisions under "The Merger Agreement Termination" beginning on page 86 and " Termination Fees and Expenses" beginning on page 87.

These provisions could discourage a potential third party acquirer from considering or proposing an alternative acquisition, even if it were prepared to pay consideration with a higher value than that proposed to be paid in the merger, or might result in a potential third party acquirer proposing to pay a lower per share price than it might otherwise have proposed to pay because of the added expense of the termination fee.

Resales of shares of Kratos common stock following the merger and additional obligations to issue shares of Kratos common stock by Kratos may cause the market price of Kratos common stock to decrease.

As of December 31, 2007, Kratos had 78,998,922 shares of common stock outstanding and approximately 8,327,306 shares of common stock subject to outstanding options and other rights to purchase or acquire its shares. Kratos currently expects that it will issue approximately 25.3 million shares of common stock in connection with the merger. The issuance of these new shares of Kratos common stock and the sale of additional shares of Kratos common stock that may become eligible for sale in the public market from time to time upon exercise of options and other equity-linked securities could have the effect of depressing the market price for shares of Kratos common stock.

Future results of the combined company may differ materially from the unaudited pro forma financial statements presented in this Proxy Statement.

The future results of Kratos may be materially different from those shown in the unaudited pro forma financial statements presented in this Proxy Statement that show only a combination of the historical results of Kratos and SYS. Kratos expects to incur significant costs associated with completing the merger and combining the operations of the two companies, and the exact magnitude of these costs is not yet known. Furthermore, these costs may decrease the capital that Kratos could use for income-earning investments in the future.

The trading price of shares of Kratos common stock after the merger may be affected by factors different from those affecting the price of shares of Kratos common stock or shares of SYS common stock before the merger.

When the merger is completed, holders of SYS common stock will become holders of Kratos common stock. The results of operations of Kratos, as well as the trading price of Kratos common stock, after the merger may be affected by factors different from those currently affecting Kratos' or SYS's results of operations and the trading price of Kratos common stock or SYS common stock.

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

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

- changes in fiscal policies or decreases in available government funding, including budgetary constraints affecting federal government spending generally, or specific departments or agencies in particular;
- the adoption of new laws or regulations or changes to existing laws or regulations;
- changes in political or social attitudes with respect to security and defense issues;
- changes in federal government programs or requirements, including the increased use of small business providers;
- changes in or delays related to government restrictions on the export of defense articles and services;
- potential delays or changes in the government appropriations process; and
- delays in the payment of our invoices by government payment offices.

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

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

Government contracts frequently include provisions that are not standard in private commercial transactions, and are subject to laws and regulations that give the Federal Government rights and remedies not typically found in commercial contracts, including provisions permitting the federal government to:

- terminate Kratos' existing contracts;
- reduce potential future income from Kratos' existing contracts;
- modify some of the terms and conditions in Kratos' existing contracts;
- suspend or permanently prohibit Kratos from doing business with the federal government or with any specific government agency;
- impose fines and penalties;

subject Kratos to criminal prosecution;

- suspend work under existing multiple year contracts and related task orders if the necessary funds are not appropriated by Congress;

- decline to exercise an option to extend an existing multiple year contract; and

- claim rights in technologies and systems invented, developed or produced by Kratos.

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

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

A significant number of Kratos' customers are government agencies which are subject to unique political and budgetary constraints and have special contracting requirements that may affect Kratos' ability to obtain other new government customers.

A significant number of Kratos' customers are government agencies, principally DoD agencies. These agencies often do not set their own budgets and therefore have little control over the amount of money they can spend. In addition, these agencies experience political pressure that may dictate the manner in which they spend money. Due to political and budgetary processes and other scheduling delays that frequently occur in the contract or bidding process, some government agency orders may be canceled or substantially delayed, and the receipt of revenues or payments may be substantially delayed.

Kratos faces intense competition from many competitors that have greater resources than Kratos does, which could result in price reductions, reduced profitability or loss of market share.

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

- divert sales from Kratos by winning very large-scale government contracts, a risk that is enhanced by the recent trend in government procurement practices to bundle services into larger contracts;

- force Kratos to charge lower prices; or

- adversely affect Kratos' relationships with current clients, including Kratos' ability to continue to win competitively awarded engagements in which Kratos is the incumbent.

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

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

Kratos has completed several acquisitions of complementary businesses in recent years, including Kratos' October 2006 acquisition of Madison Research Technology Corporation and December 2007 acquisition of Haverstick Consulting, Inc. Kratos currently expects the merger with SYS to close by the end of the second quarter of 2008 upon receipt of the required stockholder approvals. However, the merger may not close as expected, and the anticipated synergies from the acquisition may not be fully realized or may take longer to realize than expected. The success of the merger with SYS will depend in part on the success in integrating the operations, technologies and personnel of SYS. The failure to successfully integrate the operations of the two companies or otherwise to realize any of the anticipated benefits of the acquisition could seriously harm Kratos' results of operations.

Kratos continually evaluates opportunities to acquire new businesses as part of Krato's ongoing strategy, and Kratos may in the future acquire additional companies that Kratos believes could compliment or expand Kratos' business or increase Kratos' customer base. Kratos may not be able to identify suitable acquisition candidates at prices that Kratos considers appropriate. If Kratos does identify an appropriate acquisition candidate, Kratos may not be able to successfully negotiate the terms of the acquisition or finance the acquisition on terms that are satisfactory to Kratos. Negotiations of potential acquisitions and the integration of acquired business operations could disrupt Kratos' business by diverting management attention from day-to-day operations. Acquisitions of businesses or other material operations may require additional debt or equity financing, resulting in additional leverage or dilution of ownership. Kratos may encounter increased competition for acquisitions, which may increase the price of Kratos' acquisitions. Acquisitions involve numerous risks, including:

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

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

Kratos agreed to indemnify acquirers of Kratos' divested operations against specified losses in connection with the sale of these operations, and any demands for indemnification may result in expenses Kratos does not anticipate and distract the attention of Kratos' management from Kratos' continuing businesses.

Kratos agreed to indemnify acquirers of Kratos' divested operations against specified losses in connection with their sale and generally retain responsibility for various legal liabilities that accrued prior to closing. Kratos also made representations and warranties to these acquirers about the condition of the divested businesses and agreed to working capital adjustment provisions that could obligate it to make substantial payments to some of these acquirers. If any acquirer makes an indemnification claim because it has suffered a loss or a third party has commenced an action against the divested business or if Kratos is required to make payments in settlement of working capital adjustments, Kratos may incur substantial expenses resolving such claims or defending against the third party action, which would harm Kratos' operating results. In addition, Kratos' ability to defend itself may be impaired because Kratos' former employees are now employees of the acquirer or other companies, and Kratos' management may have to devote a substantial amount of time to resolving the claim. In addition, these indemnity claims may divert management attention from responsibilities related to the daily ongoing concerns of the business. In addition, Kratos may be required to expend substantial resources trying to determine which party has responsibility for the claim, even if Kratos is ultimately found to be not responsible.

A preference for minority-owned, small and small disadvantaged businesses could impact Kratos' ability to be a prime contractor on certain governmental procurements.

As a result of an SBA set-aside program, the Federal Government may decide to restrict certain procurements to bidders that qualify as minority-owned, small or small disadvantaged businesses. As a result, Kratos would not be eligible to perform as a prime contractor on those programs and would be restricted to a maximum of 49% of the work as a subcontractor on those programs. An increase in the amount of procurements under the SBA set-aside program may impact Kratos' ability to bid on new procurements or restrict Kratos' ability to recompete on incumbent work that is placed in the set-aside program.

Kratos' financial results may vary significantly from quarter to quarter.

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

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

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

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

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

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

To develop new business opportunities, Kratos primarily relies on establishing and maintaining relationships with various government entities and agencies. Kratos may be unable to successfully maintain our relationships with government entities and agencies, and any failure to do so could materially adversely affect Kratos' ability to compete successfully for new business. In addition, Kratos often acts as a subcontractor or in "teaming" arrangements in which Kratos and other contractors bid together on particular contracts or programs for the federal government or government agencies. As a subcontractor or team member, Kratos often lacks control over fulfillment of a contract, and poor performance on the contract could tarnish Kratos' reputation, even when Kratos performs as required. Kratos expects to continue to depend on relationships with other contractors for a portion of Kratos' revenue in the foreseeable future. Moreover, Kratos' revenue and operating results could be materially adversely affected if any prime contractor or teammate chooses to offer a client services of the type that Kratos provides or if any prime contractor or teammate teams with other companies to independently provide those services.

Kratos derives a significant portion of Kratos' revenues from a limited number of customers.

Kratos has derived, and believes that it will continue to derive, a significant portion of Kratos' revenues from a limited number of customers. To the extent that any significant customer uses less of Kratos' services or terminates its relationship with Kratos, our revenues could decline significantly. As a result, the loss of any significant client could seriously harm our business. For the fiscal year ended December 31, 2007, two customers comprised approximately 60% and 44% of Kratos' federal business revenues and total revenues, respectively, and Kratos' five largest customers accounted for approximately 84% and 62% of Kratos' total federal business revenues and total revenues, respectively. None of Kratos' customers are obligated to purchase additional services from Kratos. As a result, the volume of work that Kratos performs for a specific customer is likely to vary from period to period, and a significant client in one period may not use Kratos' services in a subsequent period.

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

Although fixed-price contracts entail a greater risk of a reduced profit or financial loss on a contract compared to other types of contracts Kratos enters into, fixed-price contracts typically provide higher profit opportunities because Kratos may be able to benefit from cost savings. In contrast, cost-plus-fee contracts are subject to statutory limits on profit margins, and generally are the least profitable of Kratos' contract types. Kratos' federal government customers typically determine what type of contract Kratos enters into. Cost-plus-fee and fixed-price contracts in Kratos' federal business accounted for approximately 27% and 50%, respectively, of Kratos' federal business revenues for the fiscal year ended March 30, 2008. To the extent that Kratos enters into more cost-plus-fee or less fixed-price contracts in proportion to Kratos' total contract mix in the future, Kratos' margins and operating results may suffer.

The Federal Government may revise its procurement or other practices in a manner adverse to Kratos.

The Federal Government may revise its procurement practices or adopt new contracting rules and regulations, such as cost accounting standards. It could also adopt new contracting methods relating to GSA contracts, MACs or other government-wide contracts, or adopt new standards for contract awards intended to achieve certain social or other policy objectives, such as establishing new set-aside programs for small or minority-owned businesses. In addition, the Federal Government may face restrictions from new legislation or regulations, as well as pressure from government employees and their unions, on the nature and amount of services the Federal Government may obtain from private contractors. These changes could impair Kratos' ability to obtain new contracts or contracts under which Kratos currently performs when those contracts are put up for recompetition bids. Any new contracting methods could be costly or administratively difficult for Kratos to implement, and, as a result, could harm Kratos' operating results.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Accuracy of indirect billing rates is critical.

Kratos' provisional indirect billing rates are approved at least annually by the Defense Contract Management Agency, which we refer to as the DCMA after being reviewed by the DCAA. These rates can differ from Kratos' actual indirect rates. Kratos budgets to have our actual indirect rates as close as possible to Kratos' government approved indirect rates at fiscal year end. Throughout the year, management assesses how these rates compare to forecasted rates for the year. If a variance is expected to exceed the amount to be billed, provisions for such variance are recognized at that time.

For interim reporting purposes, Kratos applies overhead and selling, general and administrative expenses as a percentage of direct contract costs based on annual budgeted indirect expense rates. To the extent actual expenses for an interim period are greater than the budgeted rates, the variance is deferred if management believes it is probable that the variance will be absorbed by planned contract activity. This probability assessment includes projecting whether future indirect costs will be sufficiently less than the annual budgeted rates or can be absorbed by seeking increased billing rates applied on cost-plus-fee contracts. At the end of each interim reporting period, management assesses the recoverability of any amount deferred to determine if any portion should be charged to expense. In assessing the recoverability of variances deferred, management takes into consideration estimates of the amount of direct labor and other direct costs to be incurred in future interim periods, the feasibility of modifications for provisional billing rates, and the likelihood that an approved increase in provisional billing rates can be passed along to a customer. If assumptions about the probability of recovering deferred variances change, deferred amounts could be expensed and such expenses could have a material adverse effect on the results of operations.

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

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

If Kratos experiences systems or service failure, Kratos' reputation could be harmed and Kratos' clients could assert claims against Kratos for damages or refunds.

Kratos creates, implements and maintains IT solutions that are often critical to Kratos' clients' operations. We have experienced, and may in the future experience, some systems and service failures, schedule or delivery delays and other problems in connection with Kratos' work. If Kratos experiences these problems, Kratos may:

- lose revenue due to adverse client reaction;
- be required to provide additional services to a client at no charge;
- receive negative publicity, which could damage Kratos' reputation and adversely affect Kratos' ability to attract or retain clients; and
- suffer claims for substantial damages.

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

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

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

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

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

Kratos is exposed to the risk that employee fraud or other misconduct could occur. Misconduct by employees could include intentional failures to comply with federal government procurement regulations, engaging in unauthorized activities or falsifying time records. Employee misconduct could also involve the improper use of Kratos' clients' sensitive or classified information, which could result in regulatory sanctions against Kratos and serious harm to Kratos' reputation and could result in a loss of contracts and a reduction in revenues. It is not always possible to deter employee misconduct, and the precautions Kratos takes to prevent and detect this activity may not be effective in controlling unknown or unmanaged risks or losses, which could cause Kratos to lose contracts or cause a reduction in revenues.

Kratos' business is dependent upon Kratos' ability to keep pace with the latest technological changes.

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

If Kratos is unable to manage its growth, Kratos' business could be adversely affected.

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

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

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

Kratos attempts to protect its trade secrets by entering into confidentiality and intellectual property assignment agreements with third parties, its employees and consultants. However, these agreements can be breached and, if they are, there may not be an adequate remedy available to Kratos. In addition, others may independently discover Kratos' trade secrets and proprietary information and in such cases Kratos could not assert any trade secret rights against such party. Enforcing a claim that a party illegally obtained and is using Kratos' trade secret is difficult, expensive and time consuming, and the outcome is unpredictable. If Kratos is unable to protect its intellectual property, its competitors could market services or products similar to its services and products, which could reduce demand for Kratos' offerings. Any litigation to enforce Kratos' intellectual property rights, protect its trade secrets or determine the validity and scope of the proprietary rights of others could result in substantial costs and diversion of resources, with no assurance of success. See "Legal Proceedings" on page 94 for additional information.

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

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

The Equity Award Review encompassed all grants of options to purchase shares of Kratos' common stock and other equity awards made since two months prior to our IPO in November 1999 through December 2006. Kratos also reviewed all option grants that were entered into its stock option database, which is known as Equity Edge, after its IPO with a grant date before November 1999, as well as other substantial grants issued prior to its IPO, consisting of more than 14,000 grants. Kratos further reviewed all option grants with a grant dat