

MERCURY COMPUTER SYSTEMS INC

Form 10-Q

November 04, 2011

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

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

FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2011

OR

.. **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE TRANSITION PERIOD FROM TO**

COMMISSION FILE NUMBER: 0-23599

MERCURY COMPUTER SYSTEMS, INC.

(Exact name of registrant as specified in its charter)

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MASSACHUSETTS
(State or other jurisdiction of

04-2741391
(I.R.S. Employer

incorporation or organization)

Identification No.)

201 RIVERNECK ROAD

CHELMSFORD, MA
(Address of principal executive offices)

01824
(Zip Code)

978-256-1300

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 229.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

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

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

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

Shares of Common Stock outstanding as of October 31, 2011: 30,610,532 shares

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MERCURY COMPUTER SYSTEMS, INC.

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Table of Contents**PART I. FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS****MERCURY COMPUTER SYSTEMS, INC.****CONSOLIDATED BALANCE SHEETS**

(In thousands, except share and per share data)

(Unaudited)

| | September 30, 2011 | June 30, 2011 |
|--|-----------------------|------------------|
| Assets | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 165,862 | \$ 162,875 |
| Accounts receivable, net of allowance for doubtful accounts of \$27 and \$17 at September 30, 2011 and June 30, 2011, respectively | 38,128 | 44,786 |
| Unbilled receivables | 1,202 | 1,059 |
| Inventory | 24,502 | 18,540 |
| Deferred income taxes | 6,896 | 7,678 |
| Prepaid income taxes | 371 | 1,075 |
| Prepaid expenses and other current assets | 4,242 | 4,171 |
| Total current assets | 241,203 | 240,184 |
| Restricted cash | 3,000 | 3,000 |
| Property and equipment, net | 14,221 | 14,520 |
| Goodwill | 79,558 | 79,558 |
| Acquired intangible assets, net | 15,906 | 16,702 |
| Other non-current assets | 926 | 1,598 |
| Total assets | \$ 354,814 | \$ 355,562 |
| Liabilities and Shareholders' Equity | | |
| Current liabilities: | | |
| Accounts payable | \$ 12,539 | \$ 7,972 |
| Accrued expenses | 6,192 | 5,607 |
| Accrued compensation | 7,474 | 16,288 |
| Income taxes payable | 473 | 201 |
| Deferred revenues and customer advances | 4,994 | 6,138 |
| Total current liabilities | 31,672 | 36,206 |
| Deferred gain on sale-leaseback | 5,267 | 5,556 |
| Deferred income taxes | 3,652 | 3,877 |
| Income taxes payable | 1,777 | 1,777 |
| Other non-current liabilities | 5,764 | 6,710 |
| Total liabilities | 48,132 | 54,126 |
| Commitments and contingencies (Note H) | | |
| Shareholders' equity: | | |
| Preferred stock, \$.01 par value; 1,000,000 shares authorized; no shares issued or outstanding | | |

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| | | |
|--|----------------|----------------|
| Common stock, \$.01 par value; 85,000,000 shares authorized; 29,405,518 and 29,143,738 shares issued and outstanding at September 30, 2011 and June 30, 2011, respectively | 294 | 291 |
| Additional paid-in capital | 216,309 | 213,777 |
| Retained earnings | 88,766 | 86,113 |
| Accumulated other comprehensive income | 1,313 | 1,255 |
| Total shareholders' equity | 306,682 | 301,436 |
| Total liabilities and shareholders' equity | \$ 354,814 | \$ 355,562 |

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

Table of Contents**MERCURY COMPUTER SYSTEMS, INC.****CONSOLIDATED STATEMENTS OF OPERATIONS**

(In thousands, except per share data)

(Unaudited)

| | Three Months Ended September 30, | |
|--|---|-------------|
| | 2011 | 2010 |
| Net revenues | \$ 49,122 | \$ 52,108 |
| Cost of revenues | 19,206 | 21,448 |
| Gross margin | 29,916 | 30,660 |
| Operating expenses: | | |
| Selling, general and administrative | 13,645 | 14,197 |
| Research and development | 11,865 | 10,899 |
| Amortization of acquired intangible assets | 816 | 319 |
| Acquisition costs and other related expenses | 25 | |
| Total operating expenses | 26,351 | 25,415 |
| Income from operations | 3,565 | 5,245 |
| Interest income | 6 | 7 |
| Interest expense | (9) | (9) |
| Other income, net | 405 | 516 |
| Income from continuing operations before income taxes | 3,967 | 5,759 |
| Income taxes | 1,314 | 2,077 |
| Income from continuing operations | 2,653 | 3,682 |
| Loss from discontinued operations, net of income taxes | | (52) |
| Net income | \$ 2,653 | \$ 3,630 |
| Basic net earnings per share: | | |
| Income from continuing operations | \$ 0.09 | \$ 0.16 |
| Loss from discontinued operations | | |
| Net income | \$ 0.09 | \$ 0.16 |
| Diluted net earnings per share: | | |
| Income from continuing operations | \$ 0.09 | \$ 0.16 |
| Loss from discontinued operations | | |
| Net income | \$ 0.09 | \$ 0.16 |
| Weighted-average shares outstanding: | | |
| Basic | 29,277 | 22,944 |
| Diluted | 30,033 | 23,411 |

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Comprehensive income:

| | | |
|--|----------|----------|
| Net income | \$ 2,653 | \$ 3,630 |
| Foreign currency translation adjustments | 63 | 166 |
| Net unrealized loss on investments | (5) | |
| Total comprehensive income | \$ 2,711 | \$ 3,796 |

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

Table of Contents**MERCURY COMPUTER SYSTEMS, INC.****CONSOLIDATED STATEMENTS OF CASH FLOWS**

(In thousands)

(Unaudited)

| | Three Months Ended September 30, | |
|--|---|------------------|
| | 2011 | 2010 |
| Cash flows from operating activities: | | |
| Net income | \$ 2,653 | \$ 3,630 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization expense | 2,671 | 1,747 |
| Stock-based compensation expense | 2,040 | 1,290 |
| Provision for deferred income taxes | 557 | 138 |
| Excess tax benefit from stock-based compensation | (405) | (481) |
| Other non-cash items | (174) | (246) |
| Changes in operating assets and liabilities: | | |
| Accounts receivable | 6,541 | 4,314 |
| Inventory | (5,964) | (1,204) |
| Prepaid income taxes | 704 | 1,800 |
| Prepaid expenses and other current assets | (58) | (704) |
| Other non-current assets | 719 | (739) |
| Accounts payable and accrued expenses | (3,672) | (1,558) |
| Deferred revenues and customer advances | (1,436) | (503) |
| Income taxes payable | 678 | 1,652 |
| Other non-current liabilities | (638) | 214 |
| Net cash provided by operating activities | 4,216 | 9,350 |
| Cash flows from investing activities: | | |
| Sales and maturities of marketable securities | | 18,025 |
| Purchases of property and equipment | (1,646) | (1,595) |
| Payments for acquired intangible assets | (20) | (558) |
| Net cash (used in) provided by investing activities | (1,666) | 15,872 |
| Cash flows from financing activities: | | |
| Proceeds from employee stock plans | 90 | 294 |
| Excess tax benefits from stock-based compensation | 405 | 554 |
| Payments of deferred offering costs | (30) | |
| Payments of capital lease obligations | (59) | (78) |
| Net cash provided by financing activities | 406 | 770 |
| Effect of exchange rate changes on cash and cash equivalents | 31 | 6 |
| Net increase in cash and cash equivalents | 2,987 | 25,998 |
| Cash and cash equivalents at beginning of period | 162,875 | 56,241 |
| Cash and cash equivalents at end of period | \$ 165,862 | \$ 82,239 |

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| | | |
|--|----------|------------|
| Cash paid (received) during the period for: | | |
| Interest | \$ 9 | \$ 2 |
| Income taxes | \$ (624) | \$ (1,631) |
| Supplemental disclosures non-cash activities: | | |
| Issuance of restricted stock awards to employees | \$ 3,587 | \$ 6,543 |

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

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MERCURY COMPUTER SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Amounts in thousands except per share data)

(Unaudited)

A. Description of Business

Mercury Computer Systems, Inc. (the Company or Mercury) designs, manufactures and markets commercially-developed, high-performance embedded, real-time digital signal and image processing sub-systems and software for specialized defense and commercial computing markets. The Company's solutions play a critical role in a wide range of applications, transforming sensor data to information for analysis and interpretation. In military reconnaissance and surveillance platforms, the Company's sub-systems process real-time radar, video, sonar and signals intelligence data. The Company provides microwave products for enhanced communications capabilities in military and commercial applications. Additionally, the Company entered the prime defense contracting market space in fiscal 2008 through the creation of its wholly-owned subsidiary, Mercury Federal Systems, Inc. (MFS), to focus on reaching the federal intelligence and homeland security agencies.

The Company's products and solutions address mission-critical requirements within the defense industry for C4ISR (command, control, communications, computers, intelligence, surveillance and reconnaissance) and electronic warfare, or EW, systems and services, and target several markets including maritime defense, airborne reconnaissance, ballistic missile defense, ground mobile and force protection systems and tactical communications and network systems. The Company's products or solutions have been deployed in approximately 300 different programs with over 25 different prime defense contractors.

B. Summary of Significant Accounting Policies

BASIS OF PRESENTATION AND PRINCIPLES OF CONSOLIDATION

The accompanying consolidated financial statements have been prepared by the Company in accordance with accounting principles generally accepted in the United States of America (U.S. GAAP) for interim financial information and with the instructions to the Form 10-Q and Article 10 of Regulation S-X. Certain information and footnote disclosures, normally included in annual consolidated financial statements have been condensed or omitted pursuant to those rules and regulations; however, in the opinion of management the financial information reflects all adjustments, consisting of adjustments of a normal recurring nature, necessary for fair presentation. These consolidated financial statements should be read in conjunction with the audited consolidated financial statements and related notes for the fiscal year ended June 30, 2011 which are contained in the Company's Annual Report on Form 10-K filed with the Securities and Exchange Commission (SEC) on August 18, 2011. The results for the three months ended September 30, 2011 are not necessarily indicative of the results to be expected for the full fiscal year.

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries. All intercompany transactions and balances have been eliminated.

USE OF ESTIMATES

The preparation of financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the dates of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ from those estimates.

REVENUE RECOGNITION

The Company enters into multiple-deliverable arrangements that may include a combination of hardware components, related integration or other services. These arrangements generally do not include any

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performance-, cancellation-, termination- or refund-type provisions. Total revenue recognized under multiple-deliverable revenue arrangements was approximately 45% and 55% of total revenues in the three months ended September 30, 2011 and 2010, respectively. Approximately 50% of the Company's multiple-deliverable revenue arrangements typically ship complete within the same quarter.

Each deliverable within the Company's multiple-deliverable revenue arrangements is accounted for as a separate unit of accounting under the guidance of Financial Accounting Standards Board (FASB) Accounting Standards Update (ASU) 2009-13 if both of the following criteria are met: the delivered item or items have value to the customer on a standalone basis; and for an arrangement that includes a general right of return relative to the delivered item(s), delivery or performance of the undelivered item(s) is considered probable and substantially in the control of the Company. The Company considers a deliverable to have standalone value if the item is sold separately by the Company or another vendor or could be resold by the customer. Further, the Company's revenue arrangements generally do not include a general right of return relative to delivered products.

Deliverables not meeting the criteria for being a separate unit of accounting are combined with a deliverable that does meet that criterion. The appropriate allocation of arrangement consideration and recognition of revenue is then determined for the combined unit of accounting.

The Company allocates arrangement consideration to each deliverable in an arrangement based on its relative selling price. The Company determines the selling price of its deliverables based on the following hierarchy: (1) vendor-specific objective evidence (VSOE) if available; (2) third-party evidence (TPE) if VSOE is not available; and (3) best estimated selling price (BESP) if neither VSOE nor TPE is available. The Company is not able to establish TPE due to the nature of the markets in which the Company competes, and, as such, the Company determines selling price using VSOE or BESP.

VSOE is generally limited to the price charged when the same or similar product is sold separately or, if applicable, the stated substantive renewal rate in the agreement. If a product or service is seldom sold separately, it is unlikely that the Company can determine VSOE for the product or service. The Company defines VSOE as a median price of recent standalone transactions that are priced within a narrow range, as defined by the Company.

The Company's determination of BESP involves a weighting of several factors based on the specific facts and circumstances of the arrangement. Specifically, the Company considers the cost to produce the deliverable, the anticipated margin on that deliverable, the selling price and profit margin for similar parts, the Company's ongoing pricing strategy and policies (as evident in the price list as established and updated on a regular basis), the value of any enhancements that have been built into the deliverable and the characteristics of the varying markets in which the deliverable is sold. The Company will determine BESP for deliverables in future agreements based on the specific facts and circumstances of each arrangement.

The Company analyzes the selling prices used in its allocation of arrangement consideration at a minimum on an annual basis. Selling prices are analyzed on a more frequent basis if a significant change in the Company's business necessitates a more timely analysis or if the Company experiences significant fluctuations in the selling prices of its products.

WEIGHTED-AVERAGE SHARES

Weighted-average shares were calculated as follows:

| | Three Months Ended September 30, | |
|--|---|---------------|
| | 2011 | 2010 |
| Basic weighted-average shares outstanding | 29,277 | 22,944 |
| Effect of dilutive equity instruments | 756 | 467 |
| Diluted weighted-average shares outstanding | 30,033 | 23,411 |

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Equity instruments to purchase 913 and 1,576 shares of common stock were not included in the calculation of diluted net earnings per share for the three months ended September 30, 2011 and 2010, respectively, because the equity instruments were anti-dilutive.

RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS

In September 2011, the FASB issued ASU 2011-08, *Intangibles - Goodwill and Other (Topic 350): Testing Goodwill for Impairment*, an amendment of the FASB Accounting Standards Codification. The ASU permits an entity to make a qualitative assessment of whether it is more likely than not that a reporting unit's fair value is less than its carrying amount before applying the two-step goodwill impairment test. If an entity concludes it is not more likely than not that the fair value of a reporting unit is less than its carrying amount, it does not need to perform the two-step impairment test. The ASU is effective for annual and interim goodwill impairment tests performed for fiscal years beginning after December 15, 2011. This guidance is not expected to have a material impact to the Company's consolidated financial statements.

C. Acquisitions

On January 12, 2011, the Company entered into a stock purchase agreement (the "Stock Purchase Agreement") with LNX Corporation ("LNX"), the holders of the equity interests of LNX, and Lamberto Raffaelli, as the sellers' representative (collectively, the "Sellers"). Pursuant to the Stock Purchase Agreement, the Company completed its purchase of all of the outstanding equity interests in LNX, and LNX became a wholly-owned subsidiary of the Company. Based in Salem, NH, LNX designs and builds next generation radio frequency receivers for signal intelligence, communication intelligence as well as electronic attack applications. LNX is included in the Advanced Computing Solutions ("ACS") business unit.

The Company acquired LNX for a purchase price of \$31,000 paid in cash, plus an earnout of up to \$5,000 payable in cash, based upon achievement of financial targets during calendar years 2011 and 2012. The purchase price was subject to post-closing adjustment based on a determination of LNX's closing net working capital. The Company funded the purchase price with cash on hand. The Company acquired LNX free of bank debt. Immediately prior to the consummation of the acquisition, LNX divested its non-defense global procurement business. The Company determined the fair value of the contingent consideration as part of the LNX acquisition based on the probability of LNX attaining the specified financial targets and assigned a fair value of \$4,828 to the liability. As of September 30, 2011, the Company expects to achieve the financial targets and to pay the full earnout. In accordance with the Stock Purchase Agreement, \$6,200 of the purchase price was placed into escrow to support the post-closing working capital adjustment and the sellers' indemnification obligations, of which \$1,523 was released to the Sellers and \$27 was released to the Company in March 2011, upon the final calculation of net working capital. The remaining escrow is available for indemnification claims through August 2012.

The allocation of the purchase price to the net assets and liabilities acquired is subject to subsequent adjustment as the Company obtains additional information during the measurement period and finalizes its fair value estimates. Any subsequent adjustments to these fair value estimates occurring during the measurement period will result in an adjustment to goodwill or income, as applicable. There were no material adjustments to the initial fair value estimates.

The Company incurred \$25 in acquisition costs and other related expenses during the three months ended September 30, 2011, which were expensed as incurred.

D. Goodwill and Acquired Intangible Assets

The carrying amount of goodwill at September 30, 2011 and June 30, 2011 was \$79,558. In the three months ended September 30, 2011, there were no triggering events, as defined by FASB Accounting Standard

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Codification (ASC) 350, Intangibles Goodwill and Other (FASB ASC 350) which required an interim goodwill impairment test. The Company performs its annual goodwill impairment test in the fourth quarter of each fiscal year.

The Company determines its reporting units in accordance with FASB ASC 350, by assessing whether discrete financial information is available and if management regularly reviews the operating results of that component. Following this assessment, the Company determined that its reporting units are the same as its operating segments, ACS and MFS. As of June 30, 2011, ACS was the only reporting unit that had a goodwill balance, and as such, the annual impairment analysis was performed for this reporting unit only.

Acquired intangible assets consisted of the following:

| | Gross Carrying Amount | Accumulated Amortization | Net Carrying Amount | Weighted Average Useful Life |
|--|-----------------------------|-----------------------------|---------------------------|---------------------------------------|
| September 30, 2011 | | | | |
| Customer relationships | \$ 18,300 | \$ (7,823) | \$ 10,477 | 6.7 years |
| Licensing agreements, trademarks and patents | 4,065 | (1,900) | 2,165 | 5.5 years |
| Completed technologies | 2,900 | (348) | 2,552 | 6.0 years |
| Backlog | 800 | (288) | 512 | 2.0 years |
| Non-compete agreements | 500 | (300) | 200 | 5.0 years |
| | \$ 26,565 | \$ (10,659) | \$ 15,906 | |
| June 30, 2011 | | | | |
| Customer relationships | \$ 18,300 | \$ (7,530) | \$ 10,770 | 6.7 years |
| Licensing agreements, trademarks and patents | 4,045 | (1,622) | 2,423 | 5.5 years |
| Completed technologies | 2,900 | (227) | 2,673 | 6.0 years |
| Backlog | 800 | (188) | 612 | 2.0 years |
| Non-compete agreements | 500 | (276) | 224 | 5.0 years |
| | \$ 26,545 | \$ (9,843) | \$ 16,702 | |

Estimated future amortization expense for acquired intangible assets remaining at September 30, 2011 is as follows:

| | Year Ending June 30, |
|--|-------------------------|
| 2012 | \$ 1,997 |
| 2013 | 2,849 |
| 2014 | 2,833 |
| 2015 | 2,693 |
| 2016 | 2,326 |
| Thereafter | 3,208 |
| Total future amortization expense | \$ 15,906 |

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The Company measures at fair value certain financial assets and liabilities, including cash equivalents, restricted cash and contingent consideration. FASB ASC 820, *Fair Value Measurement and Disclosures*, specifies a hierarchy of valuation techniques based on whether the inputs to those valuation techniques are observable or unobservable. Observable inputs reflect market data obtained from independent sources, while unobservable inputs reflect the Company's market assumptions. These two types of inputs have created the following fair-value hierarchy:

Level 1 Quoted prices for identical instruments in active markets;

Level 2 Quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-derived valuations in which all significant inputs and significant value drivers are observable in active markets; and

Level 3 Valuations derived from valuation techniques in which one or more significant inputs or significant value drivers are unobservable.

The following table summarizes the Company's financial assets and liabilities measured at fair value on a recurring basis at September 30, 2011:

| | Fair Value Measurements | | | |
|--|-------------------------|-------------------|-----------|-----------|
| | September 30, 2011 | Level 1 | Level 2 | Level 3 |
| Assets: | | | | |
| U.S. Treasury bills and money market funds | \$ 156,040 | \$ 156,040 | \$ | \$ |
| Restricted cash | 3,000 | 3,000 | | |
| Total | \$ 159,040 | \$ 159,040 | \$ | \$ |
| Liabilities: | | | | |
| Contingent consideration | \$ 4,877 | \$ | \$ | \$ 4,877 |

The carrying values of cash and cash equivalents, accounts receivable and payable, and accrued liabilities approximate fair value due to the short-term maturities of these assets and liabilities.

The Company determines the fair value of the contingent consideration related to the LNX acquisition based on the probability of LNX attaining specific financial targets using an appropriate discount rate to present value the liability. The following table provides a rollforward of the fair value of the contingent consideration, whose fair values were determined by Level 3 inputs:

| | Fair Value |
|--|-----------------|
| Balance at June 30, 2011 | \$ 4,854 |
| Recognition of accretion expense in operating expenses | 23 |
| Balance at September 30, 2011 | \$ 4,877 |

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Inventory is stated at the lower of cost (first-in, first-out) or market value, and consists of materials, labor and overhead. On a quarterly basis, the Company uses consistent methodologies to evaluate inventory for net realizable value. The Company reduces the value of inventory for excess and obsolete inventory, consisting of on-hand and non-cancelable on-order inventory in excess of estimated usage. The excess and obsolete inventory evaluation is based upon assumptions about future demand, product mix and possible alternative uses. Inventory was comprised of the following:

| | September 30, 2011 | June 30, 2011 |
|-----------------|-----------------------|------------------|
| Raw materials | \$ 8,886 | \$ 7,314 |
| Work in process | 8,872 | 7,554 |
| Finished goods | 6,744 | 3,672 |
| Total | \$ 24,502 | \$ 18,540 |

There are no amounts in inventory relating to contracts having production cycles longer than one year.

G. Debt*Senior Secured Credit Facility*

The Company has a loan and security agreement (the "Loan Agreement") with Silicon Valley Bank that provides a \$35,000 revolving line of credit (the "Revolver"), with interest payable monthly and the principal due at the February 11, 2014 maturity of the Revolver. The Loan Agreement provides for conventional affirmative and negative covenants, including a minimum quick ratio of 1.0 to 1.0 and a \$15,000 minimum trailing four quarter cash flow covenant through and including June 30, 2012 (with \$17,500 of minimum cash flow required thereafter). The minimum cash flow covenant is calculated as the Company's trailing-four quarter adjusted EBITDA as defined in the Loan Agreement. In addition, the Loan Agreement contains certain customary representations and warranties and limits the Company's and its subsidiaries' ability to incur liens, dispose of assets, carry out certain mergers and acquisitions, make investments and capital expenditures and defines events of default and limitations on the ability of the Company and its subsidiaries to incur additional debt. The interest rates include various rate options that are available to the Company. The rates are calculated using a combination of conventional base rate measures plus a margin over those rates. The base rates consist of LIBOR rates and prime rates. The actual rates will depend on the level of these underlying rates plus a margin based on the Company's leverage at the time of borrowing. Borrowings are secured by a first-priority security interest in all of the Company's domestic assets, including intellectual property, but limited to 65% of the voting stock of foreign subsidiaries. The Company's MFS and LNX subsidiaries are guarantors and have granted a security interest in their assets in favor of Silicon Valley Bank. The Company has had no borrowings under the Loan Agreement since inception and was in compliance with all covenants as of September 30, 2011.

H. Commitments and Contingencies

LEGAL CLAIMS

The Company is subject to legal proceedings, claims and tax audits that arise in the ordinary course of business. The Company does not believe the outcome of these matters will have a material adverse effect on its financial position, results of operations or cash flows.

INDEMNIFICATION OBLIGATIONS

The Company's standard product sales and license agreements entered into in the ordinary course of business typically contain an indemnification provision pursuant to which the Company indemnifies, holds

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harmless, and agrees to reimburse the indemnified party for losses suffered or incurred by the indemnified party in connection with any patent, copyright or other intellectual property infringement claim by any third party with respect to the Company's products. Such provisions generally survive termination or expiration of the agreements. The potential amount of future payments the Company could be required to make under these indemnification provisions is, in some instances, unlimited.

In connection with the divestitures of the Company's former VI, VSG, Biotech and ES/PS businesses, which occurred in January 2009, June 2009, September 2008, and May 2008, respectively, the Company provided indemnification to the buyers of the respective businesses. The Company's indemnification obligations generally cover the buyers for damages resulting from breaches of representations, warranties and covenants contained in the applicable purchase and sale agreement and generally cover pre-closing tax liabilities of the divested businesses. The Company's indemnification obligations related to divested businesses are generally subject to caps and expire at various defined future dates.

PURCHASE COMMITMENTS

In September 2006, the Company entered into a supply agreement with a third-party vendor to purchase certain inventory parts that went end of life. This supply agreement, as subsequently amended, commits the vendor to acquiring and storing approximately \$6,500 of inventory until August 31, 2012 and allows the Company to place orders for the inventory four times a year. Upon the earlier of January 31, 2007 or completion of the wafer fabrication process, the Company was required to and paid approximately \$1,900 of the \$6,500. Further, upon expiration of the agreement on August 31, 2012, if the Company does not purchase the full \$6,500 in inventory, it may be required to pay a penalty equal to 35% of the remaining inventory balance. As of September 30, 2011, the remaining minimum commitment related to this agreement was \$1,599, which is the 35% penalty on the remaining inventory balance. As of September 30, 2011, the Company has recorded an accrued liability of approximately \$586 for the 35% penalty it anticipates paying for unpurchased inventory.

As of September 30, 2011, the Company has entered into non-cancelable purchase commitments for certain inventory components and services used in its normal operations. The purchase commitments covered by these agreements are for less than one year and aggregate to approximately \$16,695.

I. Stock-Based Compensation

STOCK OPTION PLANS

The number of shares authorized for issuance under the Company's 2005 Stock Incentive Plan, as amended and restated (the 2005 Plan) is 5,092 shares, which will be increased by any future cancellations, forfeitures or terminations (other than by exercise) under the Company's 1997 Stock Option Plan (the 1997 Plan). The 2005 Plan provides for the grant of non-qualified and incentive stock options, restricted stock, stock appreciation rights and deferred stock awards to employees and non-employees. All stock options are granted with an exercise price of not less than 100% of the fair value of the Company's common stock at the date of grant and the options generally have a term of seven years. There were 2,156 shares available for future grant under the 2005 Plan at September 30, 2011.

The number of shares authorized for issuance under the 1997 Plan was 8,650 shares, of which 100 shares could be issued pursuant to restricted stock grants. The 1997 Plan provided for the grant of non-qualified and incentive stock options and restricted stock to employees and non-employees. All stock options were granted with an exercise price of not less than 100% of the fair value of the Company's common stock at the date of grant. The options typically vest over periods of zero to four years and have a maximum term of 10 years. Following shareholder approval of the 2005 Plan on November 14, 2005, the Company's Board of Directors directed that no further grants of stock options or other awards would be made under the 1997 Plan, and the 1997 Plan subsequently expired in June 2007. The foregoing does not affect any outstanding awards under the 1997 Plan, which remain in full force and effect in accordance with their terms.

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EMPLOYEE STOCK PURCHASE PLAN

The number of shares authorized for issuance under the Company's 1997 Employee Stock Purchase Plan, as amended and restated (ESPP), is 1,100 shares. Under the ESPP, rights are granted to purchase shares of common stock at 85% of the lesser of the market value of such shares at either the beginning or the end of each six-month offering period. The ESPP permits employees to purchase common stock through payroll deductions, which may not exceed 10% of an employee's compensation as defined in the ESPP with a total share cap during each six-month offering period. There were no shares issued under the ESPP during the three months ended September 30, 2011 and 2010. Shares available for future purchase under the ESPP totaled 164 at September 30, 2011.

STOCK OPTION AND AWARD ACTIVITY

The following table summarizes activity of the Company's stock option plans since June 30, 2010:

| | Number of Shares | Options Outstanding Weighted Average Exercise Price | Weighted Average Remaining Contractual Term (Years) |
|--|---------------------|---|--|
| Outstanding at June 30, 2010 | 2,612 | \$ 13.70 | 4.69 |
| Granted | 77 | 13.70 | |
| Exercised | (315) | 8.25 | |
| Cancelled | (81) | 16.41 | |
| Outstanding at June 30, 2011 | 2,293 | \$ 14.35 | 3.88 |
| Granted | | | |
| Exercised | (14) | 6.32 | |
| Cancelled | (9) | 18.70 | |
| Outstanding at September 30, 2011 | 2,270 | \$ 14.39 | 3.63 |

The following table summarizes the status of the Company's non-vested restricted stock awards since June 30, 2010:

| | Non-vested Restricted Stock Awards Number of Shares | Weighted Average Grant Date Fair Value |
|--|--|--|
| Outstanding at June 30, 2010 | 828 | \$ 9.44 |
| Granted | 738 | 12.47 |
| Vested | (279) | 9.42 |
| Forfeited | (100) | 10.57 |
| Outstanding at June 30, 2011 | 1,187 | \$ 11.23 |
| Granted | 234 | 15.37 |
| Vested | (248) | 10.66 |
| Forfeited | (15) | 9.34 |
| Outstanding at September 30, 2011 | 1,158 | \$ 12.21 |

STOCK-BASED COMPENSATION EXPENSE

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The Company recognized the full impact of its share-based payment plans in the consolidated statements of operations for the three months ended September 30, 2011 and 2010 in accordance with FASB ASC 718, *Compensation - Stock Compensation* (FASB ASC 718), and did not capitalize any such costs on the

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consolidated balance sheets, as costs that qualified for capitalization were not material. Under the fair value recognition provisions of FASB ASC 718, stock-based compensation cost is measured at the grant date based on the value of the award and is recognized as expense over the service period. The following table presents stock-based compensation expenses included in the Company's consolidated statement of operations:

| | Three Months Ended September 30, | |
|---|---|-------------|
| | 2011 | 2010 |
| Cost of revenues | \$ 88 | \$ 43 |
| Selling, general and administrative | 1,675 | 1,140 |
| Research and development | 277 | 107 |
| Stock-based compensation expense before tax | 2,040 | 1,290 |
| Income taxes | (719) | (448) |
| Net compensation expense | \$ 1,321 | \$ 842 |

J. Operating Segment, Geographic Information and Significant Customers

Operating segments are defined as components of an enterprise evaluated regularly by the Company's senior management in deciding how to allocate resources and assess performance. The Company is organized in two business segments. These reportable segments were determined based upon the nature of the products offered to customers, the market characteristics of each operating segment and the Company's management structure:

Advanced Computing Solutions (ACS). This business unit is focused on specialized, high performance signal end-to-end processing solutions that encompass signal acquisition including microwave front-end, digitalization, computing, storage and communications, targeted to key market segments, including defense, communications and other commercial application.

Mercury Federal Systems (MFS). This business unit is focused on services and support work with the Department of Defense and federal intelligence and homeland security agencies, including designing and engineering new ISR capabilities to address present and emerging threats to U.S. forces.

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The accounting policies of the reportable segments are the same as those described in Note B: Summary of Significant Accounting Policies. The profitability measure employed by the Company and its chief operating decision maker (CODM) for making decisions about allocating resources to segments and assessing segment performance was income (loss) from operations prior to stock compensation expense. As such, stock-based compensation expense has been excluded from each operating segments income (loss) from operations below and reported separately to reconcile the reported segment income (loss) from operations to the consolidated operating income reported in the consolidated statements of operations. Additionally, asset information by reportable segment is not reported because the Company and its CODM utilize consolidated asset information when making business decisions. The following is a summary of the performance of the Company s operations by reportable segment:

| | ACS | MFS | Stock Compensation Expense | Eliminations | Total |
|--|-----------|----------|----------------------------------|--------------|-----------|
| THREE MONTHS ENDED | | | | | |
| SEPTEMBER 30, 2011 | | | | | |
| Net revenues to unaffiliated customers | \$ 45,397 | \$ 4,171 | \$ | \$ (446) | \$ 49,122 |
| Intersegment revenues | 1,932 | | | (1,932) | |
| Net revenues | \$ 47,329 | \$ 4,171 | \$ | \$ (2,378) | \$ 49,122 |
| Income (loss) from operations | \$ 5,046 | \$ 493 | \$ (2,040) | \$ 66 | \$ 3,565 |
| Depreciation and amortization expense | \$ 2,656 | \$ 15 | \$ | \$ | \$ 2,671 |
| THREE MONTHS ENDED | | | | | |
| SEPTEMBER 30, 2010 | | | | | |
| Net revenues to unaffiliated customers | \$ 50,475 | \$ 1,854 | \$ | \$ (221) | \$ 52,108 |
| Intersegment revenues | 1,408 | | | (1,408) | |
| Net revenues | \$ 51,883 | \$ 1,854 | \$ | \$ (1,629) | \$ 52,108 |
| Income (loss) from operations | \$ 7,865 | \$ (497) | \$ (1,290) | \$ (833) | \$ 5,245 |
| Depreciation and amortization expense | \$ 1,738 | \$ 9 | \$ | \$ | \$ 1,747 |

The geographic distribution of the Company s revenues from continuing operations is summarized as follows:

| | U.S. | Europe | Asia Pacific | Eliminations | Total |
|--|-----------|----------|--------------|--------------|-----------|
| THREE MONTHS ENDED | | | | | |
| SEPTEMBER 30, 2011 | | | | | |
| Net revenues to unaffiliated customers | \$ 46,877 | \$ 792 | \$ 1,453 | \$ | \$ 49,122 |
| Inter-geographic revenues | 2,182 | 257 | 20 | (2,459) | |
| Net revenues | \$ 49,059 | \$ 1,049 | \$ 1,473 | \$ (2,459) | \$ 49,122 |
| THREE MONTHS ENDED | | | | | |
| SEPTEMBER 30, 2010 | | | | | |
| Net revenues to unaffiliated customers | \$ 50,663 | \$ 1,054 | \$ 391 | \$ | \$ 52,108 |
| Inter-geographic revenues | 1,456 | 644 | 93 | (2,193) | |
| Net revenues | \$ 52,119 | \$ 1,698 | \$ 484 | \$ (2,193) | \$ 52,108 |

Foreign revenue is based on the country in which the Company s legal subsidiary is domiciled.

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The geographic distribution of the Company's long-lived assets from continuing operations is summarized as follows:

| | U.S. | Europe | Asia Pacific | Eliminations | Total |
|--------------------|-----------|--------|--------------|--------------|-----------|
| September 30, 2011 | \$ 14,196 | \$ 21 | \$ 4 | \$ | \$ 14,221 |
| June 30, 2011 | \$ 15,390 | \$ 24 | \$ 704 | \$ | \$ 16,118 |

Identifiable long-lived assets exclude goodwill and intangible assets.

Customers comprising 10% or more of the Company's revenues for the periods shown below are as follows:

| | Three Months Ended September 30, | |
|------------------------------|-------------------------------------|------|
| | 2011 | 2010 |
| Raytheon Company | 21% | 17% |
| Northrop Grumman Corporation | 18% | 23% |
| Lockheed Martin Corporation | 12% | 13% |
| KLA-Tencor Corporation | * | 11% |
| ASML Holding N.V. | * | 10 |
| | 51% | 74% |

* Indicates that the amount is less than 10% of the Company's revenues for the respective period.

Although the Company typically has several customers from which it derives 10% or more of its revenue, the sales to each of these customers are spread across multiple programs and platforms. For the three months ended September 30, 2011, only the Joint Strike Fighter program at 16% comprised more than 10% of the Company's revenues. For the three months ended September 30, 2010, no single program comprised 10% or more of the Company's revenues.

K. Income Taxes

The Company recorded tax expense of \$1,314 and \$2,077 for the three months ended September 30, 2011 and 2010, respectively, on income from continuing operations before taxes of \$3,967 and \$5,759 for the three months ended September 30, 2011 and 2010, respectively. Income tax expense for the three months ended September 30, 2011 differed from the federal statutory rate primarily due to the impact of a Section 199 manufacturing deduction and research and development tax credits. Income tax expense for the three months ended September 30, 2010 differed from the federal statutory rate primarily due to the impact of a Section 199 manufacturing deduction.

No material changes in the Company's unrecognized tax positions occurred during the three months ended September 30, 2011. The Company does not expect there to be any material changes in its reserves for unrecognized tax benefits within the next 12 months.

L. Subsequent Events

The Company has evaluated subsequent events from the date of the consolidated balance sheet through the date the consolidated financial statements were issued.

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ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS FORWARD-LOOKING STATEMENTS

From time to time, information provided, statements made by our employees or information included in our filings with the Securities and Exchange Commission may contain statements that are not historical facts but that are forward-looking statements, which involve risks and uncertainties. The words may, will, would, should, could, plan, expect, anticipate, continue, estimate, project, intend, similar expressions are intended to identify forward-looking statements regarding events, conditions and financial trends that may affect our future plans of operations, business strategy, results of operations and financial position. These forward-looking statements, which include those related to our strategic plans, business outlook, and future business and financial performance, involve risks and uncertainties that could cause actual results to differ materially from those projected or anticipated. Such risks and uncertainties include, but are not limited to, general economic and business conditions, including unforeseen economic weakness in our markets, effects of continued geo-political unrest and regional conflicts, competition, changes in technology and methods of marketing, delays in completing various engineering and manufacturing programs, changes in customer order patterns, changes in product mix, continued success in technological advances and delivering technological innovations, continued funding of defense programs and the timing of such funding, changes in the U.S. Government's interpretation of federal procurement rules and regulations, market acceptance of our products, shortages in components, production delays due to performance quality issues with outsourced components, inability to fully realize the expected benefits from acquisitions or divestitures or delays in realizing such benefits, challenges in integrating acquired businesses and achieving anticipated synergies, changes to export regulations, increases in tax rates, changes to generally accepted accounting principles, difficulties in retaining key employees and customers, unanticipated costs under fixed-price service and system integration engagements, and various other factors beyond our control. These risks and uncertainties also include such additional risk factors as set forth under Part I-Item 1A (Risk Factors) in the Company's Annual Report on Form 10-K for the fiscal year ended June 30, 2011. We caution readers not to place undue reliance upon any such forward-looking statements, which speak only as of the date made. We undertake no obligation to update any forward-looking statement to reflect events or circumstances after the date on which such statement is made.

OVERVIEW

We design, manufacture and market commercially-developed, high-performance embedded, real-time digital signal and image processing sub-systems and software for specialized defense and commercial computing markets. Our solutions play a critical role in a wide range of applications, transforming sensor data to information for analysis and interpretation. In military reconnaissance and surveillance platforms, our sub-systems process real-time radar, video, sonar and signals intelligence, or SIGINT, data. We provide microwave products for enhanced communications capabilities in military and commercial applications. Additionally, we entered the prime defense contracting market space in fiscal 2008 through the creation of our wholly-owned subsidiary, Mercury Federal Systems, Inc., to focus on reaching the federal intelligence and homeland security agencies.

Our products and solutions address mission-critical requirements within the defense industry for C4ISR (command, control, communications, computers, intelligence, surveillance and reconnaissance) and electronic warfare, or EW, systems and services, and target several markets including maritime defense, airborne reconnaissance, ballistic missile defense, ground mobile and force protection systems and tactical communications and network systems. Our products or solutions have been deployed in approximately 300 different programs with over 25 different prime defense contractors.

As of September 30, 2011, we had 604 employees and, for the three months ended September 30, 2011, we had revenues of \$49.1 million and income from continuing operations of \$2.7 million.

Advanced Computing Solutions, or ACS. This business unit is focused on specialized, high performance signal end-to-end processing solutions that encompass signal acquisition including microwave front-end,

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digitalization, computing, storage and communications, targeted to key market segments, including defense, communications and other commercial application. ACS's open system architecture solutions span the full range of embedded technologies from board level products to fully integrated sub-systems. Our products utilize leading-edge processor technologies architected to address highly data-intensive applications that include signal, sensor and image processing within environmentally constrained military and commercial applications. In addition, ACS now has a portfolio of microwave sub-assemblies to address needs in EW, SIGINT, electronic intelligence, or ELINT, and high bandwidth communications subsystems.

These products are highly optimized for size, weight and power, as well as for the performance and ruggedization requirements of our customers. Customized design and sub-systems integration services extend our capabilities to tailor solutions to meet the specialized requirements of our customers. For the three months ended September 30, 2011, ACS accounted for 92% of our total net revenues.

Mercury Federal Systems, or MFS. This business unit is focused on services and support work with the Department of Defense, or the DoD, and federal intelligence and homeland security agencies, including designing and engineering new intelligence, surveillance and reconnaissance, or ISR, capabilities to address present and emerging threats to U.S. forces. MFS is part of our long-term strategy to expand our software and services presence and pursue growth in platform-ready ISR sub-systems, particularly those with classified intellectual property. MFS offers a wide range of engineering architecture and design services that enable clients to deploy leading edge computing capabilities for ISR systems on an accelerated time cycle. This business unit enables us to combine classified intellectual property with the commercially developed application-ready sub-systems being developed by ACS, providing customers with platform-ready, affordable ISR sub-systems. For the three months ended September 30, 2011, MFS accounted for 8% of our total net revenues.

Since we are an OEM supplier to our commercial markets and conduct business with our defense customers via commercial items, requests by customers are a primary driver of revenue fluctuations from quarter to quarter. Customers specify delivery date requirements that coincide with their need for our products. Because these customers may use our products in connection with a variety of defense programs or other projects of different sizes and durations, a customer's orders for one quarter generally do not indicate a trend for future orders by that customer. Additionally, order patterns do not necessarily correlate amongst customers and, therefore, we generally cannot identify sequential quarterly trends, even within our business units. As an industry, we are dealing with a federal continuing budget resolution and longer-term uncertainties in the defense budget. Although the federal government is expected to pass a budget by the end of calendar 2011, the possibility of the government operating under a continuing resolution beyond calendar 2011 cannot be ruled out.

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The following tables set forth, for the three months periods indicated, financial data from the consolidated statements of operations:

| (In thousands) | September 30, 2011 | As a % of Total Net Revenue | September 30, 2010 | As a % of Total Net Revenue |
|---|-----------------------|-----------------------------------|-----------------------|-----------------------------------|
| Net revenues | \$ 49,122 | 100.0% | \$ 52,108 | 100.0% |
| Cost of revenues | 19,206 | 39.1 | 21,448 | 41.2 |
| Gross margin | 29,916 | 60.9 | 30,660 | 58.8 |
| Operating expenses: | | | | |
| Selling, general and administrative | 13,645 | 27.8 | 14,197 | 27.2 |
| Research and development | 11,865 | 24.1 | 10,899 | 20.9 |
| Amortization of acquired intangible assets | 816 | 1.6 | 319 | 0.6 |
| Acquisition costs and other related expenses | 25 | 0.1 | | |
| Total operating expenses | 26,351 | 53.6 | 25,415 | 48.7 |
| Income from operations | 3,565 | 7.3 | 5,245 | 10.1 |
| Other income, net | 402 | 0.8 | 514 | 1.0 |
| Income from continuing operations before income taxes | 3,967 | 8.1 | 5,759 | 11.1 |
| Income taxes | 1,314 | 2.7 | 2,077 | 4.0 |
| Income from continuing operations | 2,653 | 5.4 | 3,682 | 7.1 |
| Loss from discontinued operations, net of taxes | | | (52) | (0.1) |
| Net income | \$ 2,653 | 5.4% | \$ 3,630 | 7.0% |

REVENUES

| (In thousands) | September 30, 2011 | September 30, 2010 | \$ Change | % Change |
|-----------------------|-----------------------|-----------------------|-------------------|-------------|
| ACS | \$ 45,397 | \$ 50,475 | \$ (5,078) | (10)% |
| MFS | 4,171 | 1,854 | 2,317 | 125% |
| Other | (446) | (221) | (225) | 102% |
| Total revenues | \$ 49,122 | \$ 52,108 | \$ (2,986) | (6)% |

Total revenues decreased \$3.0 million, or 6%, to \$49.1 million during the three months ended September 30, 2011 as compared to the comparable period in fiscal 2011. International revenues represented approximately 5% and 4% of total revenues during the three months ended September 30, 2011 and 2010, respectively.

Net ACS revenues decreased \$5.1 million, or 10%, during the three months ended September 30, 2011 as compared to the same period in fiscal 2011. This decrease was primarily driven by lower commercial sales of \$10.3 million which were partially offset by a \$5.0 million increase in defense sales.

Net MFS revenues increased \$2.3 million during the three months ended September 30, 2011 as compared to the same period in fiscal 2011. This increase was primarily driven by higher revenues from a wide area persistent surveillance contract.

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Net Other revenues decreased \$0.2 million during the three months ended September 30, 2011 as compared to the same period in fiscal 2011. Net Other revenue is attributable to development programs where the revenue is recognized in both segments under contract accounting, and reflects the reconciliation to our consolidated results.

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GROSS MARGIN

Gross margin was 60.9% for the three months ended September 30, 2011, an increase of 210 basis points from the 58.8% gross margin achieved during the same period in fiscal 2011. The increase in gross margin was primarily due to a favorable shift in program mix including \$1.8 million of royalty revenues. These higher margins were partially offset by increases in manufacturing variances, inventory provisions, and scrap.

SELLING, GENERAL AND ADMINISTRATIVE

Selling, general and administrative expenses decreased \$0.6 million, or 4%, to \$13.6 million during the three months ended September 30, 2011, compared to \$14.2 million during the comparable period in fiscal 2011. The decrease was primarily due to a \$0.6 million decrease in variable compensation expense, a \$0.4 million decrease in distributor costs, a \$0.2 million decrease in consultant expense and a \$0.2 million decrease in recruiting expense. These decreases were partially offset by a \$0.5 million increase in stock based compensation and a \$0.2 million increase in depreciation expense. Selling, general and administrative expenses increased as a percentage of revenues to 27.8% during the three months ended September 30, 2011 from 27.2% during the same period in fiscal 2011.

RESEARCH AND DEVELOPMENT

Research and development expenses increased \$1.0 million, or 9%, to \$11.9 million during the three months ended September 30, 2011, compared to \$10.9 million during the comparable period in fiscal 2011. The increase was primarily due to a \$1.4 million increase in employee compensation expense, including stock-based compensation. The increase was also driven by an increase in headcount as a result of the LNX acquisition in January 2011. The employee compensation expense increases were partially offset by a \$0.6 million decrease in costs of prototype and development materials and a \$0.2 million decrease in variable compensation expenses. Research and development continues to be a focus of our business with approximately 24.1% and 20.9% of our revenues dedicated to research and development activities during the three months ended September 30, 2011 and 2010, respectively.

AMORTIZATION OF ACQUIRED INTANGIBLE ASSETS

Amortization of acquired intangible assets increased \$0.5 million, to \$0.8 million for the three months ended September 30, 2011 as compared to \$0.3 million during the comparable period in fiscal 2011, primarily due to amortization of intangible assets from the LNX acquisition completed during the third quarter of fiscal 2011.

ACQUISITION COSTS AND OTHER RELATED EXPENSES

We incurred a minimal amount of acquisition costs and other related expenses during three months ended September 30, 2011, incurred in connection with the acquisition of LNX Corporation.

INTEREST INCOME

Interest income for the three months ended September 30, 2011 and 2010 were minimal due to the near zero percent yield on our U.S. treasury bills and money market accounts.

INTEREST EXPENSE

We incurred a minimal amount of interest expense for the three months ended September 30, 2011 and 2010, which primarily consisted of finance charges related to capital lease obligations.

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OTHER NET INCOME

Other net income decreased \$0.1 million, or 22%, to \$0.4 million during the three months ended September 30, 2011, as compared to the same period in fiscal 2011. Other income consists of \$0.3 million in amortization of the gain on the sale leaseback of our corporate headquarters located in Chelmsford, Massachusetts and \$0.1 million foreign currency exchange gains. The \$0.1 million decrease is primarily associated with a \$0.1 million foreign currency exchange gain during the three months ended September 30, 2011 as compared to a \$0.2 million foreign currency exchange gain for the same period in fiscal 2011.

INCOME TAXES

We recorded a provision for income taxes of \$1.3 million during the three months ended September 30, 2011 reflecting a 34.1% effective tax rate as compared to 35.9% effective tax rate for the same period in fiscal 2011. Our effective tax rate for the three months ended September 30, 2011 differed from the federal statutory tax rate of 35% primarily due to the impact of a Section 199 manufacturing deduction and research and development tax credits. Our effective tax rate for the three months ended September 30, 2010 differed from the federal statutory rate primarily due to the impact of a Section 199 manufacturing deduction.

SEGMENT OPERATING RESULTS

Operating profit for ACS decreased \$2.9 million during the three months ended September 30, 2011 to \$5.0 million as compared to \$7.9 million for the same period in fiscal 2011. The decrease in operating profit was primarily driven by lower revenues of \$5.1 million.

Results from operations of the MFS segment increased \$1.0 million during the three months ended September 30, 2011 to operating income of \$0.5 million. The increase in results from operations was primarily due to a \$2.3 million increase in revenues. Additionally MFS received a higher gross margin percentage of 19% during the three months ended September 30, 2011 compared to a 7% gross margin for the same period in fiscal 2011 while lowering its administrative expenses.

See Note J to our consolidated financial statements included in this report for more information regarding our operating segments.

NON-GAAP FINANCIAL MEASURES

In our periodic communications, we discuss two important measures that are not calculated according to U.S. generally accepted accounting principles (GAAP), adjusted EBITDA and free cash flow. Adjusted EBITDA is defined as earnings from continuing operations before interest income and expense, income taxes, depreciation, amortization of acquired intangible assets, restructuring, impairment of long-lived assets, acquisition costs and other related expenses, fair value adjustments from purchase accounting and stock-based compensation costs. We use adjusted EBITDA as an important indicator of the operating performance of our business. We use adjusted EBITDA in internal forecasts and models when establishing internal operating budgets, supplementing the financial results and forecasts reported to our board of directors, determining a component of bonus compensation for executive officers and other key employees based on operating performance and evaluating short-term and long-term operating trends in our operations. We believe the adjusted EBITDA financial measure assists in providing a more complete understanding of our underlying operational measures to manage our business, to evaluate our performance compared to prior periods and the marketplace, and to establish operational goals. We believe that these non-GAAP financial adjustments are useful to investors because they allow investors to evaluate the effectiveness of the methodology and information used by management in our financial and operational decision-making.

Adjusted EBITDA is a non-GAAP financial measure and should not be considered in isolation or as a substitute for financial information provided in accordance with GAAP. This non-GAAP financial measure may

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not be computed in the same manner as similarly titled measures used by other companies. We expect to continue to incur expenses similar to the adjusted EBITDA financial adjustments described above, and investors should not infer from our presentation of this non-GAAP financial measure that these costs are unusual, infrequent or non-recurring.

The following table reconciles our income from continuing operations, the most directly comparable GAAP financial measure to our adjusted EBITDA:

| (In thousands) | Three Months Ended September 30, | |
|---|-------------------------------------|-----------------|
| | 2011 | 2010 |
| Income from continuing operations | \$ 2,653 | \$ 3,682 |
| Interest expense, net | 3 | 2 |
| Income tax expense | 1,314 | 2,077 |
| Depreciation | 1,855 | 1,428 |
| Amortization of acquired intangible assets | 816 | 319 |
| Acquisition costs and other related expenses | 25 | |
| Fair value adjustments from purchase accounting | 23 | |
| Stock-based compensation cost | 2,040 | 1,290 |
| Adjusted EBITDA | \$ 8,729 | \$ 8,798 |

Free cash flow, a non-GAAP measure for reporting cash flow, is defined as cash provided by operating activities less capital expenditures for property and equipment, which includes capitalized software development costs. We believe free cash flow provides investors with an important perspective on cash available for investments and acquisitions after making capital investments required to support ongoing business operations and long-term value creation. We believe that trends in our free cash flow are valuable indicators of our operating performance and liquidity.

Free cash flow is a non-GAAP financial measure and should not be considered in isolation or as a substitute for financial information provided in accordance with GAAP. This non-GAAP financial measure may not be computed in the same manner as similarly titled measures used by other companies. We expect to continue to incur expenditures similar to the free cash flow adjustment described above, and investors should not infer from our presentation of this non-GAAP financial measure that these expenditures reflect all of our obligations which require cash.

The following table reconciles cash provided by operating activities, the most directly comparable GAAP financial measure to free cash flow.

| (In thousands) | Three Months Ended September 30, | |
|---------------------------------------|-------------------------------------|-----------------|
| | 2011 | 2010 |
| Cash provided by operating activities | \$ 4,216 | \$ 9,350 |
| Purchases of property and equipment | (1,646) | (1,595) |
| Free cash flow | \$ 2,570 | \$ 7,755 |

LIQUIDITY AND CAPITAL RESOURCES

Our primary source of liquidity came from existing cash and cash generated from operations. Our near-term fixed commitments for cash expenditures consist primarily of payments under operating leases, a supply agreement and inventory purchase commitments with our contract manufacturers. We do not currently have any material commitments for capital expenditures.

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Based on our current plans and business conditions, we believe that existing cash, cash equivalents, available line of credit with Silicon Valley Bank, and cash generated from operations will be sufficient to satisfy our anticipated cash requirements for at least the next twelve months. However, additional cash may be required for certain future acquisitions. To the extent existing resources and cash from operations are insufficient to support our acquisition activities; we may need to raise additional funds through equity or debt financing.

Senior Secured Credit Facility

We have a loan and security agreement (the *Loan Agreement*) with Silicon Valley Bank that provides a \$35 million revolving line of credit (the *Revolver*), with interest payable monthly and the principal due at the February 11, 2014 maturity of the Revolver. The Loan Agreement provides for conventional affirmative and negative covenants, including a minimum quick ratio of 1.0 to 1.0 and a \$15 million minimum trailing four quarter cash flow covenant through and including June 30, 2012 (with \$17.5 million of minimum cash flow required thereafter). The minimum cash flow covenant is calculated as our trailing-four quarter adjusted EBITDA as defined in the Loan Agreement. In addition, the Loan Agreement contains certain customary representations and warranties and limits our and our subsidiaries' ability to incur liens, dispose of assets, carry out certain mergers and acquisitions, make investments and capital expenditures and defines events of default and limitations on the ability of us and our subsidiaries to incur additional debt. The interest rates include various rate options that are available to us. The rates are calculated using a combination of conventional base rate measures plus a margin over those rates. The base rates consist of LIBOR rates and prime rates. The actual rates will depend on the level of these underlying rates plus a margin based on our leverage at the time of borrowing. Borrowings are secured by a first-priority security interest in all of our domestic assets, including intellectual property, but limited to 65% of the voting stock of foreign subsidiaries. Our MFS and LNX subsidiaries are guarantors and have granted a security interest in their assets in favor of Silicon Valley Bank. We have had no borrowings under the Loan Agreement since inception and were in compliance with all covenants as of September 30, 2011.

Shelf Registration Statement

On August 2, 2011, we filed a shelf registration statement on Form S-3 with the SEC. The shelf registration statement, which has been declared effective by the SEC, registered up to \$500 million of debt securities, preferred stock, common stock, warrants and units. We intend to use the proceeds from a financing using the shelf registration statement for general corporate purposes, which may include the following:

the acquisition of other companies or businesses;

the repayment and refinancing of debt;

capital expenditures;

working capital; and

other purposes as described in the prospectus supplement.

CASH FLOWS

| (In thousands) | As of and for the period ended September 30, | |
|---|--|-----------|
| | 2011 | 2010 |
| Net cash provided by operating activities | \$ 4,216 | \$ 9,350 |
| Net cash (used in) provided by investing activities | \$ (1,666) | \$ 15,872 |
| Net cash provided by financing activities | \$ 406 | \$ 770 |

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| | | |
|--|------------|-----------|
| Net increase in cash and cash equivalents | \$ 2,987 | \$ 25,998 |
| Cash and cash equivalents at end of period | \$ 165,862 | \$ 82,239 |

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Our cash and cash equivalents increased by \$3.0 million from June 30, 2011 to September 30, 2011, primarily as a result of the \$4.2 million generated by operating activities, and \$0.5 million generated from stock related activities from employee stock plans, offset by \$1.7 million in capital expenditures.

Operating Activities

During the three months ended September 30, 2011, we generated \$4.2 million in cash from operations compared to \$9.4 million generated from operating activities during the same period in fiscal 2011. The \$5.2 million decrease in cash generated from operations was largely driven by \$1.0 million in comparative lower net income, a \$4.8 million increase in cash used for inventory, a \$2.1 million increase in cash used for accounts payable and accrued expenses, a \$1.1 million decrease in cash generated from prepaid income taxes, a \$1.0 million increase in cash used for income tax payable, and a \$1.8 million increase in cash used for deferred revenue, customer advances and other non-current liabilities. These uses of cash were offset by a \$2.2 million increase in cash received from accounts receivable, a \$1.5 million increase in cash generated from other non-current assets, a \$0.6 million increase in cash generated from prepaid expenses and other current assets, a \$0.9 million increase in depreciation and amortization expenses, a \$0.8 million increase in stock-based compensation, and a \$0.6 million increase in deferred income tax provision and other non-cash items. Our ability to generate cash from operations in future periods will depend in large part on profitability, the rate of collection of accounts receivable, our inventory turns and our ability to manage other areas of working capital.

Investing Activities

During the three months ended September 30, 2011, we used cash of \$1.7 million in investing activities compared to \$15.9 million generated by investing activities during the same period in fiscal 2011. The \$17.6 million decrease in cash generated from investing activities was primarily the result of exercising the put option to sell our auction rated securities balance to UBS at par. The transaction was settled on July 1, 2010 when we received \$18.0 million in cash. Additionally, there was a \$0.1 million increase in purchases of property and equipment, offset by a \$0.5 million decrease in payments for intangible assets.

Financing Activities

During the three months ended September 30, 2011, we generated \$0.4 million in cash from financing activities compared to \$0.8 million generated from financing activities during the same period in fiscal 2011. The \$0.4 million decrease in cash generated from financing activities was primarily due to a \$0.2 million decrease in proceeds from employee stock plans and a \$0.1 million decrease in excess tax benefit from stock-based compensation.

COMMITMENTS AND CONTRACTUAL OBLIGATIONS

The following is a schedule of our commitments and contractual obligations outstanding at September 30, 2011:

| (In thousands) | Total | Less Than 1 Year | 2-3 Years | 4-5 Years | More Than 5 Years |
|---------------------------|-----------|---------------------|--------------|--------------|----------------------|
| Purchase obligations | \$ 16,695 | \$ 16,695 | \$ | \$ | \$ |
| Operating leases | 13,600 | 3,068 | 4,977 | 4,379 | 1,176 |
| Supply agreement | 1,599 | 1,599 | | | |
| Capital lease obligations | 156 | 140 | 16 | | |
| | \$ 32,050 | \$ 21,502 | \$ 4,993 | \$ 4,379 | \$ 1,176 |

We have a liability at September 30, 2011 of \$1.8 million for uncertain tax positions that have been taken or are expected to be taken in various income tax returns. We do not know the ultimate resolution of these uncertain tax positions and as such, do not know the ultimate timing of payments related to this liability. Accordingly, these amounts are not included in the above table.

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Purchase obligations represent open non-cancelable purchase commitments for certain inventory components and services used in normal operations. The purchase commitments covered by these agreements are for less than one year and aggregated approximately \$16.7 million at September 30, 2011.

In September 2006, we entered into a supply agreement with a third-party vendor to purchase certain inventory parts that went end of life. This supply agreement, as subsequently amended, commits the vendor to acquiring and storing approximately \$6.5 million of inventory until August 31, 2012 and allows us to place orders for the inventory four times a year. Under the terms of this supply agreement, we were required to and paid an advance of approximately \$1.9 million of the \$6.5 million. Further, upon expiration of the agreement on August 31, 2012, if we do not purchase the full \$6.5 million in inventory, we may be required to pay a penalty equal to 35% of the remaining inventory balance. As of September 30, 2011, the remaining minimum commitment related to this agreement was \$1.6 million, which is the 35% penalty on the remaining inventory balance. While we expect to continue to purchase this inventory through the expiration of the agreement, we do not expect to purchase the full \$6.5 million noted above. As of September 30, 2011, we have recorded an accrued liability of approximately \$0.6 million for the 35% penalty we anticipate paying for unpurchased inventory.

Our standard product sales and license agreements entered into in the ordinary course of business typically contain an indemnification provision pursuant to which we indemnify, hold harmless, and agree to reimburse the indemnified party for losses suffered or incurred by the indemnified party in connection with certain intellectual property infringement claims by any third party with respect to our products. Such provisions generally survive termination or expiration of the agreements. The potential amount of future payments we could be required to make under these indemnification provisions is, in some instances, unlimited.

OFF-BALANCE SHEET ARRANGEMENTS

We provided indemnification to the buyers of our former businesses. Our indemnification obligations generally cover the buyers for damages resulting from breaches of representations, warranties and covenants contained in the applicable purchase and sale agreement and generally cover pre-closing tax liabilities of the divested businesses. Our indemnification obligations regarding the divested businesses are generally subject to caps on our obligations.

Other than the indemnification relating to the divestitures of our former businesses which have finite terms, our lease commitments incurred in the normal course of business and certain other indemnification provisions, we do not have any off- balance sheet financing arrangements or liabilities, guarantee contracts, retained or contingent interests in transferred assets, or any obligation arising out of a material variable interest in an unconsolidated entity. We do not have any majority-owned subsidiaries that are not consolidated in the financial statements. Additionally, we do not have an interest in, or relationships with, any special purpose entities.

RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS

In September 2011, the FASB issued ASU 2011-08, *Intangibles - Goodwill and Other (Topic 350): Testing Goodwill for Impairment*, an amendment of the FASB Accounting Standards Codification. The ASU permits an entity to make a qualitative assessment of whether it is more likely than not that a reporting unit's fair value is less than its carrying amount before applying the two-step goodwill impairment test. If an entity concludes it is not more likely than not that the fair value of a reporting unit is less than its carrying amount, it does not need to perform the two-step impairment test. The ASU is effective for annual and interim goodwill impairment tests performed for fiscal years beginning after December 15, 2011. This guidance is not expected to have a material impact to our consolidated financial statements.

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ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

There were no material changes in our exposure to market risk from June 30, 2011 to September 30, 2011.

ITEM 4. CONTROLS AND PROCEDURES

(a) Evaluation of Disclosure Controls and Procedures

We conducted an evaluation under the supervision and with the participation of our management, including the Chief Executive Officer and Chief Financial Officer (our principal executive officer and principal financial officer, respectively), regarding the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934 as amended (the Exchange Act)) as of the end of the period covered by this report. Based on this evaluation, management has concluded that our disclosure controls and procedures are effective. We continue to review our disclosure controls and procedures and may from time to time make changes aimed at enhancing their effectiveness and to ensure that our systems evolve with our Company's business. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met.

(b) Changes in Internal Control Over Financial Reporting

There was no change in our internal control over financial reporting (as defined in Rules 13c-15(f) and 15d-15(f) under the Exchange Act) that occurred during the quarter ended September 30, 2011 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

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PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

We are subject to legal proceedings, claims and tax audits that arise in the ordinary course of business and in the opinion of management the outcome of these matters will not have a material adverse effect on our financial position, results of operations or cash flows.

ITEM 1A. RISK FACTORS

You should carefully review and consider the information regarding certain factors that could materially affect our business, financial condition or future results set forth under Item 1A (Risk Factors) in our Annual Report on Form 10-K for the fiscal year ended June 30, 2011. There have been no material changes from the factors disclosed in our 2011 Annual Report on Form 10-K filed on August 18, 2011, although we may disclose changes to such factors or disclose additional factors from time to time in our future filings with the Securities and Exchange Commission.

ITEM 6. EXHIBITS

The following Exhibits are filed or furnished, as applicable, herewith:

- 31.1 Certification of the Company's Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 31.2 Certification of the Company's Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 32.1+ Certification of the Company's Chief Executive Officer and Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- 101* The following materials from the Company's Quarterly Report on the Form 10-Q for the quarter ended September 30, 2011 formatted in XBRL (eXtensible Business Reporting Language): (i) the Consolidated Balance Sheets; (ii) the Consolidated Statements of Operations; (iii) the Consolidated Statements of Cash Flows; and (iv) notes to the Consolidated Financial Statements

+ Furnished herewith. This certificate shall not be deemed filed for purposes of Section 18 of the Securities Exchange Act of 1934, or otherwise subject to the liability of that section, nor shall it be incorporated by reference into any filing under the Securities Act of 1933 or the Securities Exchange Act of 1934.

* As provided in Rule 406T of Regulation S-T, this information is furnished and not filed for purposes of Sections 11 and 12 of the Securities Act of 1933 and Section 18 of the Securities Exchange Act of 1934.

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MERCURY COMPUTER SYSTEMS, INC.

Signatures

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized, in Chelmsford, Massachusetts, on November 4, 2011.

MERCURY COMPUTER SYSTEMS, INC.

By: /s/ ROBERT E. HULT
Robert E. Hult

Senior Vice President,

Chief Financial Officer, and Treasurer