

ANNUAL REPORT 2002

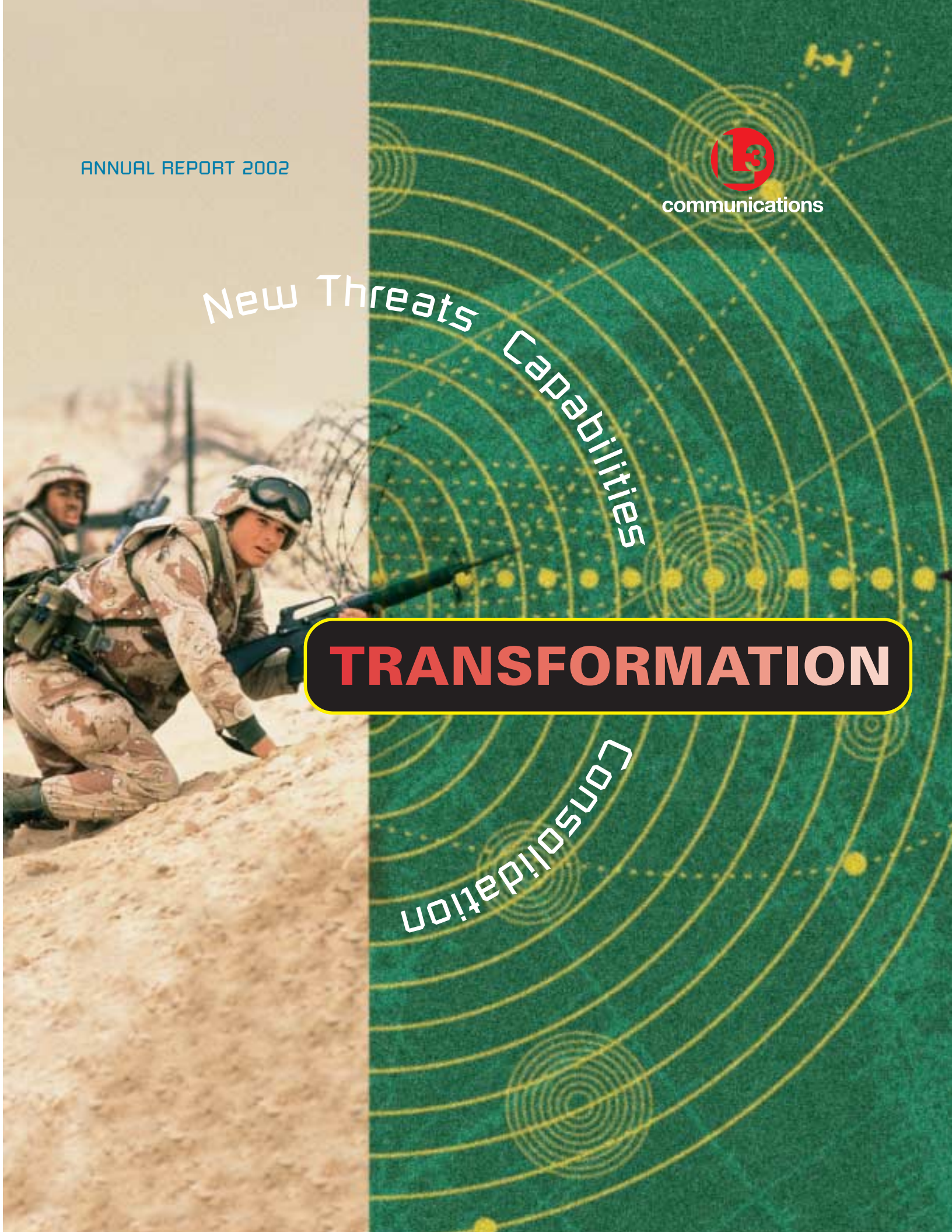


communications

New Threats
Capabilities

TRANSFORMATION

Consolidation







communications

FINANCIAL HIGHLIGHTS

For the years ended December 31,	2002	2001	2000	1999	1998
<i>(In thousands, except per share amounts)</i>					
Sales	\$4,011,229	\$2,347,422	\$1,910,061	\$1,405,462	\$1,037,045
Operating income ^(a)	453,979	275,330	222,718	150,486	100,349
Income before extraordinary loss and cumulative effect of a change in accounting principle ^(a)	212,325^(b)	115,458	82,727	58,689	32,551
Diluted earnings per share before extraordinary loss and cumulative effect of a change in accounting principle ^{(a) (c)}	2.29^(b)	1.47	1.18	0.88	0.63
Free cash flow ^(d)	259,950	126,084	98,285	82,275	62,623
Shareholders' equity	2,202,202	1,213,892	692,569	583,175	299,974

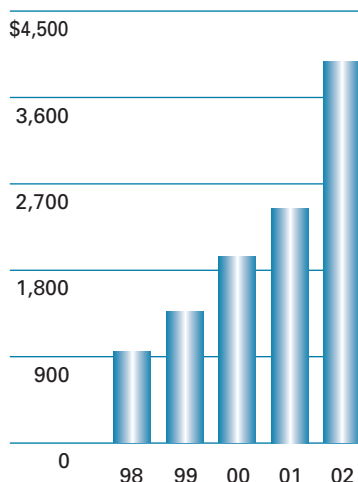
(a) The statement of operations data for periods prior to January 1, 2002 includes goodwill amortization.

(b) **Income and diluted earnings per share for the year ended December 31, 2002 is before an extraordinary loss on the early extinguishment of debt of \$9.9 million or \$0.11 per diluted share and the cumulative effect of a change in accounting principle for a goodwill impairment of \$24.4 million or \$0.25 per diluted share.**

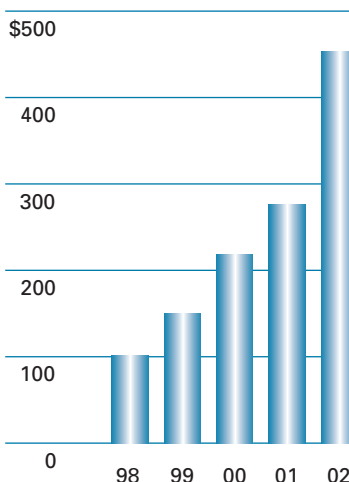
(c) Diluted earnings per share for all periods reflects our two-for-one stock split that became effective May 20, 2002.

(d) We define free cash flow as net cash from operating activities, less capital expenditures net of disposition of property, plant and equipment.

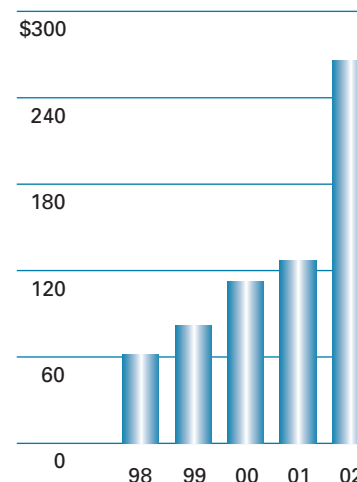
Sales in millions



Operating Income in millions



Free Cash Flow in millions



MILESTONES

March 2002 L-3 acquired Raytheon's Aircraft Integration Systems unit, a leader in Intelligence, Surveillance and Reconnaissance (ISR) systems integration. AIS was renamed L-3 Communications Integrated Systems.

April 2002 L-3 Board of Directors approved a two-for-one stock split on all shares of its common stock.

L-3 received an initial order from the Transportation Security Administration for its eXaminer 3DX™ 6000 Explosives Detection Systems (EDS). The order was subsequently increased in September 2002, funding a total of 425 EDS systems.

June 2002 L-3 Communications successfully completed its acquisition of the Detection Systems business of PerkinElmer. The new company was combined with L-3's existing EDS business to form L-3 Communications Security and Detection Systems.

June 2002 L-3 completed a public offering of 14.0 million shares. Net proceeds of this offering were used to repay existing indebtedness and for general corporate purposes, including acquisitions.

The company also sold \$750 million of 7 5/8% Senior Subordinated Notes. The company used a portion of the proceeds to retire its \$225 million of higher coupon 10 3/8% Senior Subordinated Notes.

SECURE COMMUNICATIONS & ISR SEGMENT

- Design, development & integration of ISR systems
- Secure communication links, SATCOM ground terminals
- Satellite communication & tracking; pointing, stabilization & command & control
- Digital battlefield communications & communications software support services
- Shipboard communications
- Secure voice, data & video, key management (STE, OMNI™, LMD/KP & RedEagle™)
- Private™ & OMNI_{XP}
- PrimeWave™ telecommunications equipment

- US & allied armed forces & government agencies
- U-2, GUARDRAIL, Global Hawk, Predator, other aircraft, ships, MightySat, LADS, unmanned aerial vehicles & satellites
- International Space Station, Earth Observing Satellite, Space Shuttle & NOAA weather satellites; Air Force Satellite Control Network, iPSTAR, Astrium, Coriolis, ICESAT, NEMO, Genesis, Delta launch vehicle guidance & ACTS
- US Army IBCT, ASAS, future combat systems & UAV Risk Reduction Payload
- Aegis cruisers & destroyers, Trident & Attack (688) submarines, aircraft carriers, amphibious warfare, command ships & the US Coast Guard Deepwater program
- Armed forces & government agencies
- US government, civil agencies, state emergency management agencies, nuclear power plants & multinational corporations
- Emerging competitive carriers, Internet Service Providers & developing nations

TRAINING, SIMULATION & SUPPORT SERVICES SEGMENT

- Battlefield & weapon simulation
- Worldwide training services
- Comprehensive logistics support operations & maintenance
- Information technology seat management
- Analytical & information technology support
- Communication software support and engineering development services
- Maritime simulation & training
- Crisis management

- US Army Missile Command
- Training services support to US military & allied nations
- US Special Operations Command
- Government agencies
- US intelligence community
- DoD and US government agencies
- Marine organizations
- Homeland security, law enforcement & related federal, state and local agencies

AVIATION PRODUCTS & AIRCRAFT MODERNIZATION SEGMENT

- Cockpit voice & flight data recorders & Traffic and Terrain Collision Avoidance Systems; reconnaissance
- Crash Survivable Memory Units
- Hardened Voyage Recorders
- High-performance displays and processors for airborne, shipboard and ground/vehicle applications
- Cockpit display suites
- Aircraft modernization & maintenance
- Aircraft heavy maintenance, component repair & overhaul, engineering & integrated logistics services
- Automatic Identification Systems
- Global Maritime Distress Safety System Coast Stations
- Digital Selective Calling VHF Radios

- Commercial & military aircraft; SHARP
- F-22, B-1B, JAS-39 & B-2
- Cargo vessels & passenger ships
- AH-64, A/MH-6J, C-130J, C-130H, C-27J, C-5, E-2C, F-5B, F-14, F-15, F-16, Jaguar, JA-37, JAS-39, S-211, S-3B, SH-60J, T-38, U-2, LOSAT & VISUAL
- Air transport, regional & business jets
- US & international military & government customers
- C-130, B737, B727, H3, NATO E-3A
- All ships 300 gross tons and above
- US & international Coast Guards
- Commercial and military vessels

SPECIALIZED PRODUCTS SEGMENT

- Underwater warfare systems, sonar systems, mine countermeasure systems, towed arrays; shipboard & submarine power delivery & conditioning systems
- Power delivery & electrical products
- Conventional, automated TSA-certified explosives detection systems; cargo screening inspection systems
- Airborne, ground & space telemetry & flight testing
- Ultra-wide frequency antennas, rotary joints & radomes
- Military training devices
- Event recorders
- Global satellite communications & transmission; up/down converters
- Rapid deployment satellite communication terminals
- GPS receivers, MEMS IMU, translators, simulators & ruggedized displays
- Fuzes, Safety and Arming Devices, proximity sensors
- Land navigation, fire control & missile guidance
- Turnkey automated data acquisition systems
- Microwave, satellite & wireless components & RF safety products
- Electronic wide-area security systems
- EO/IR sensors for military aircraft and UAVs
- Mobile interoperability & satellite communications vehicles/systems
- Mobile microwave & satellite communications vehicles/systems

- SH-60, EH-101, NH-90, SSN, DDG-963 & FFG-7, diesel submarines, OPVS, PBS, MCM vessels & COOPS; DDG-51, NSSN & CVN-68
- Transportation, utilities & web-based businesses
- Airports, correctional institutions, security checkpoints, ports of entry; government, commercial & military facilities
- JSF, F-15, F-16, F/A-18, F-22, Comanche, Nimrod (UK), Titan, EELV, BAE LIF, AIM-9X, JASSM, JSOW, EKV, AMRAAM, JDAM, MK-82, Patriot & THAAD missiles, GMDS, Excalibur & commercial aircraft
- Military aircraft, weather radar & air traffic control
- Flight simulators, maintenance trainers & distance learning
- Commercial rail transportation industry
- Earthwatch, IKONOS I; rural telephony, satellite news & private networks
- Mobile military forces & disaster relief applications
- Armed forces & Department of Defense
- Mortar, artillery, air-dropped bombs, submunitions, rocket & guided missiles
- MLRS, Dragonfire & CKEM
- Space Shuttle, Titan IV & EELV launch monitoring
- Emergency restoration & portable microwave communications systems, surveillance cameras for small UAVs, cellular & PCS, commercial & electronic systems for military aircraft
- Corporations & government agencies
- Maritime patrol, helicopters & UAVs
- Homeland security, law enforcement & related federal, state and local agencies
- Television industry news gathering

July 2002 L-3 acquired ComCept, Inc., a leader in network-centric warfare (NCW) capabilities, including requirements development, modeling, simulation, communications and systems development and integration for ISR.

October 2002 L-3 successfully completed the acquisition of Northrop Grumman's Electron Devices and Displays-Navigation Systems - San Diego businesses.

November 2002 L-3 completed its acquisition of all outstanding shares of common stock of Westwood Corporation, a leader in shipboard power control, switchgear and power distribution systems.

L-3 acquired International Microwave Corporation (IMC), a global communications company that provides wireless communications, network support systems, information technology, defense communications and enhanced surveillance systems.

November 2002 L-3 acquired Wescam, a leading provider of wireless visual information systems to the military and commercial sectors. Wescam adds electro-optical surveillance capabilities to L-3's Intelligence, Surveillance, Reconnaissance and Communications (ISR&C) products and subsystems.

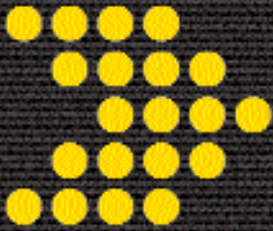
Simply put, transformation is change. It's change in the way we fight, in the way we train, in the way we exercise, but especially, it's a change in the way we think and how we approach our jobs. Changes in doctrine, in training, in organization, in the way we develop leaders, and, most important, in the way all of the services work together.

Donald H. Rumsfeld, US Secretary of Defense



communications

Not just a products company, but
a capabilities company.



Transformation



Military – Capabilities-Based

The Department of Defense (DoD) is shifting from a threat-based to a capabilities-based force structure. The military will transform itself by focusing on a number of capabilities, including broadband network-centric communications, information dominance, stealth, mobility, precision, command and control, Global Positioning Systems (GPS) and space, as well as integration and interoperability of all US forces and allies.

There is also an emphasis on using existing platforms in new ways and upgrading technology in old systems as well as developing new systems, platforms and network-centric warfare for the new battlefield. This transformation will produce increased combat power, shared awareness, increased speed of command, higher tempo operations, greater lethality, increased survivability and a degree of self-synchronization.



New Threats – Many Places

During the Cold War period, the US was prepared to fight a two-front war in the event of attack. In the 1990s, the threats began to change. Terrorist attacks against US military interests and the events of September 11th have revealed how the country has to protect itself against secretive terrorist cells and their loose alliances with rogue nations possessing weapons of mass destruction. These threats are as deadly as ever, but they have been complicated by “many faces in many places.” The nation’s military forces and federal, state and local governments have to reassess their vulnerabilities and take steps to protect citizens, armed forces and the country’s vast infrastructure.



Industry Consolidation

The end of the Cold War as well as the consolidation of the industrial base had a significant impact on the defense industry. The number of prime contractors in the US has dwindled to only five. There is concern within the DoD that such consolidation will continue to limit the flow-down of research and development funding and pressure the primes to grow revenues by moving towards more vertical integration.

These developments are just two of the factors negatively impacting the vendor supply base, smaller companies that have been traditionally responsible for the product innovation that distinguished military platforms and systems. As a result, many of these vendors do not have the liquidity or the market presence to grow. There are few billion-dollar companies left in the second tier and thousands of small specialty companies in the third tier who face elimination. L-3 has become the consolidator of the vendor base, adding to its breadth of products and preserving great legacies.



Frank C. Lanza
Chairman and Chief Executive Officer

Dear Shareholders:

A strong partnership with the Department of Defense (DoD), government agencies and allied international military forces has always been the cornerstone of L-3 Communications. In the past year, that partnership has been strengthened as L-3 aligns itself to meet emerging global challenges.

The DoD is accelerating its efforts to modernize and transform our military forces and has adjusted the national military strategy to be reflective of the challenges of the new millennium. The DoD has shifted its focus from fighting a possible two-front war to combat-

ing multiple threats — from rogue nations with weapons of mass destruction (WMD) to terrorism around the world. This shift has compelled the DoD to transform itself from a platform-centric orientation to a capabilities-based, networked military force.

Those capabilities will require realizing the promise of network-centric warfare (NCW) to provide real-time information to warfighters and leveraging the use of unmanned vehicles for more types of missions, such as combat, as well as more broadly for Intelligence, Surveillance, Reconnaissance and Communications (ISR&C). By achieving greater precision and lethality for munitions, the DoD can acquire fewer platforms and upgrade them with modern, sophisticated high-technology capabilities.



Robert V. LaPenta
President and Chief Financial Officer

This new way of fighting was displayed in Afghanistan, where 50-year-old B-52 bombers, with the aid of targeting technologies in the hands of Special Operations Forces (SOF), conducted tactical strikes using precision weapons. US national assets were also leveraged to provide friendly force tracking using a joint, interoperable system called Grenadier Brat. As a whole, the military will have a greater reliance on joint forces, coalition interoperability and innovative approaches to fighting.

Given this dynamic adjustment in requirements, L-3 has reviewed its operations to ensure that it is closely aligned with the DoD's stated direction. The company has focused its management, employees, product devel-

opment, marketing and research and development (R&D) funding to reflect this transformational philosophy.

L-3 has expanded its operations in DoD priority areas. For instance, central to the DoD's transformation is NCW, a layered architecture that enables platforms from space, air, sea and ground to share information on a real-time basis. In 2002, L-3 acquired two key participants in the military's transformational warfighting efforts to achieve the lightning capability of NCW — Raytheon's Aircraft Integration Systems and privately held ComCept, Inc.

Now known as L-3 Integrated Systems and L-3 ComCept respectively, these companies are assisting the military in charting future warfighting activities to achieve the persistent ISR needed to become a more mobile, respon-

sive and lethal force. L-3 is now at the forefront of assisting in the development of seamless, integrated Command, Control, Communications, Computers, Intelligence, Surveillance and Reconnaissance (C⁴ISR).

Important to the DoD is the ongoing survival of hundreds of small defense companies that have historically provided the innovative edge to the US military, but are now inhibited by insufficient resources. L-3 has been preserving this legacy by acquiring select companies and providing them with adequate resources that allow them to deliver essential products to the DoD and other government agencies. With the support of L-3 behind them, the future viability of these key suppliers is assured.

In addition, the US government has embarked on an examination of how to protect its citizens and infrastructure, both in this country and abroad. The newly created Department of Homeland Security (DHS) and the cabinet-level position of Secretary of Homeland Security are focusing on multi-faceted missions, including preventing terrorist attacks and safeguarding borders and critical assets, such as transportation, communications and power grids.

These requirements have increased the need for emergency preparedness, including crisis management expertise and simulation and training for first responders, secure communications, intrusion detection and sophisticated explosives detection systems for the safe transportation of people and cargo. In addition, there is a major effort underway to replace the aging assets of the US Coast Guard (USCG), whose role has been expanded beyond safety and regulatory duties to the critical task of defending the country's shores against terrorism.

On the commercial front, the weakness in the aviation and communications markets had a negative impact on L-3's business in these areas. L-3 has mitigated the financial impact of these weaknesses with continued expansion of its products for the maritime market. The International Maritime Organization (IMO) has mandated the use of Automatic Identification System (AIS) transponders in ships to provide data and manifest information necessary for monitoring safety and managing traffic. These transponders will also provide authorities with information to protect against terrorism. L-3 is a leader in this transponder market as well as in the hardened voyage recorder niche.

Another mitigating factor in 2003 is the new product launch of T²CAS™, a combined airborne traffic and terrain collision avoidance system. This product, developed in conjunction with joint-venture partner Thales, is the most advanced terrain awareness system in the industry and was recently certified by the Federal Aviation Administration (FAA). L-3 has already signed up several launch customers for this product.

Record Sales

The year 2002 was one of great progress and significant milestones for L-3. Our sales increased to \$4,011.2 million, from \$2,347.4 million in 2001, a 70.9% increase. Excluding the contributions from acquisitions, sales grew 14.8% in 2002.

Record Earnings

Operating income for L-3 rose 42.9% to \$454.0 million in 2002, increasing from \$317.6 million in 2001, after adjusting 2001 to exclude goodwill amortization. Diluted earnings per share for 2002, before an extraordinary loss on retirement of debt and the cumulative effect of a change in accounting principle for a goodwill impairment charge, rose 22.5% to \$2.29 from \$1.87 for 2001, after adjusting 2001 to exclude goodwill amortization.

Strong Balance Sheet and Record Cash Flow

L-3 closed the year with a stronger balance sheet. Our debt-to-book capitalization improved to 44.8% at December 31, 2002 from 50.8% at December 31, 2001. In 2002, L-3 raised funds to significantly reduce its leverage, strengthen its capital structure and finance acquisitions. In June, the company completed a public offering of 14 million shares of common stock, raising approxi-

Photo above:

(l. to r.) David M. Reilly, vice president, assistant general counsel and assistant secretary, Michael T. Strianese, senior vice president of finance, Richard A. Nordstrom, vice president of operations review, Ralph G. D'Ambrosio, vice president and controller, Christopher C. Cambria, senior vice president, secretary and general counsel and David T. Butler, vice president of planning.

Photo below:

(l. to r.) Robert W. RisCassi, vice president of Washington Operations, Jill J. Wittels, vice president of business development, Donald A. MacDonald, vice president-International, Dennis A. Jones, vice president of Maritime Programs, Larry L. Henry, vice president of Air Force Programs, Jimmie V. Adams, vice president of Washington Operations and Lawrence H. Schwartz, vice president of homeland security and president of the Navigation Products Group.



mately \$767 million. The company also sold \$750 million of 7 5/8% Senior Subordinated Notes. The company used a portion of the proceeds to retire its \$225 million of higher coupon 10 3/8% Senior Subordinated Notes.

For 2002, L-3 generated \$260.0 million in free cash flow, an increase of 106.2% over \$126.1 million for 2001. We ended 2002 with \$134.9 million cash on hand and \$661.4 million of available borrowings under our bank credit facilities, which are available for the company to invest in strategic acquisitions and other business opportunities.

Record Orders

L-3 achieved a record \$4,383.1 million in funded orders from all of its major business areas with a resulting backlog of \$3,228.6 million at December 31, 2002. Included among the highlights and milestones are:

Secure Communications and ISR Segment

- L-3 Integrated Systems (IS) was awarded a contract to support another important ISR platform, the Compass Call aircraft for the US Air Force, and received key bookings for the EP-3, as well as the Rivet Joint and other Big Safari platforms — major platforms forming the future network-centric constellation.
- IS will also perform the conversion of a fifth P-3C aircraft into the EP-3E signals intelligence configuration

and upgrade the C-20B and C-9C platforms in the US Air Force's Special Air Mission (SAM) fleet.

- IS is providing integration for the United Kingdom's Airborne Stand-Off Radar (ASTOR) system on the Bombardier Global Express. The ASTOR system comes complete with L-3 Communication Systems-West's NATO STANAG compliant Common Data Link (CDL) and a beyond line-of-sight Satellite Communications (SATCOM) link — enabling ASTOR to be interoperable with US and coalition forces.
- Communication Systems-West's Tactical Common Data Link (TCDL) technology was selected by the Army's Aviation Applied Technology Directorate (AATD) for its Hunter Standoff Killer Team (HSKT) Advanced Concept Technology Demonstration (ACTD).
- Communication Systems-West was awarded the prime responsibility for the Multi-Platform Common Data Link (MP-CDL) Concept Technology Development system. This system, which represents the next generation of common data link hardware, will support transmission and receipt of data between ground facilities and multiple simultaneous air vehicle platforms. L-3's MP-CDL will provide the network-centric wideband communication architecture that connects the critical information flow within the ISR community.
- Communication Systems-West also received a significant contract for the initial development of a ship-



board communications package for the US Navy's Naval Battleforce Network program.

- Communication Systems-West was selected as a member of the Boeing Integrated Defense Systems-led team for a transformational DoD initiative known as the Family of Advanced Beyond Line-of-Sight Terminals (FAB-T).
- Communication Systems-East was selected as a member of the Lockheed Martin Deepwater team to provide the shipboard and shore-based communication systems to upgrade and modernize US Coast Guard assets.
- Communication Systems-East also received additional funding for Secure Terminal Equipment (STE) and OMNI™ voice and data encryption terminals.
- Communication Systems-East also won awards for the S/TAR™ recorder and the REMBASS-II unattended ground sensor system used in intelligence operations.
- Communication Systems-East received funding for engineering analysis and studies and development of Type 1 cryptographic-based security and key management systems for Lockheed Martin's Joint Strike Fighter (JSF) program.
- Communication Systems-East won a key information security development program, GigEE, a 1-gigabit-per-second network encryptor, which is based on the company-developed RedEagle™, a 100-megabit-per-second network encryptor introduced in 2002.

Training, Simulation and Support Services Segment

- Link Simulation and Training received a contract to provide support for currently fielded US Navy and Marine Corps F/A-18 training assets at military bases in the United States and Japan.
- L-3 Analytics conducted a high-level seminar exercise for the State of Oklahoma to test and evaluate its preparedness plans in the event of an act of biological terrorism.
- EER Systems was selected by the USAF Air Combat Command to integrate Measurement and Signatures Intelligence (MASINT) capability into Air Force ground stations worldwide.

Photo:

(l. to r.) Sheila M. Sheridan, director of administration, Kenneth W. Manne, vice president of human resources, Stephen M. Souza, vice president and treasurer, Kenneth R. Goldstein, director of taxes, Vincent T. Taylor, vice president and chief information officer and Cynthia Swain, vice president of corporate communications.

- L-3 Ship Analytics won a contract to assist the State of South Carolina in enhancing its homeland security preparedness. In January 2003, Ship Analytics was selected to provide the Government of Indonesia with six fully modernized maritime training schools for the Indonesian Seafarers' IMO Certification Program.
- SYColeman also received engineering and training services awards to support US Army HQ training, US Army's Space Command (ARSPACE) and the new joint homeland defense North Command in Colorado Springs, CO and for missile defense initiatives in the design, modeling and testing of Intercontinental Ballistic Missile (ICBM) targets and interceptors.
- Coleman Aerospace received a task order from the US Air Force Space and Missile Systems Center (SMC) for the Missile Defense Agency (MDA) and one for a demonstration mission of the Long Range Air Launch Target (LRALT) system for the Theater Missile Defense program.

Aviation Products and Aircraft Modernization Segment

- In March 2003, L-3 IS won the single largest award in the history of L-3 Communications, a \$1.5 billion, competitively awarded Indefinite Delivery/Indefinite Quantity (IDIQ) program to provide logistics, products and services to the US Special Operations Command (USSOCOM).
- Display Systems was selected as the *Boeing 2002 Supplier of the Year for Aerospace Support* and won a contract to provide high-resolution Flat Panel Up-Front Control Panels for the F-15K cockpit.
- Display Systems won an award to provide high-resolution displays for AH-64 Apache helicopter simulators.
- Display Systems was selected to supply multifunction displays and electronic flight instruments to the USAF, Lockheed Martin and international customers for use on various models of the C-130 Hercules aircraft.
- Display Systems was also awarded the next two lots of multifunction displays and electronic engine displays for use on the USAF T-38 trainer aircraft.
- Spar Aerospace received additional funding from Canada for the C-130 Integrated Support Contract and finalized the contract for the avionics upgrade of the Hellenic Air Force's fleet of C-130 aircraft.
- The ACSS Terrain and Traffic Collision Avoidance System (T²CAS) products, which have been certified by the FAA, were ordered by Federal Express, the US

Customs Service, Northwest Airlines, Virgin Express, Aeromexico, Mesaba and Aero California. ACSS was also awarded a contract to be the standard Traffic Alert and Collision Avoidance System (TCAS) supplier for the Dassault Falcon F7X business jet.

- IS received official acceptance of its modernized AP-3C aircraft by the Royal Australian Air Force as an upgrade of the Australian fleet of maritime patrol aircraft.
- IS also delivered three aircraft to Raytheon for the System for the Vigilance of the Amazon (SIVAM), developed for Brazil to monitor the Amazon rain forest.
- IS received and mounted a 2.5-meter, 40,000 pound telescope assembly from Germany for integration aboard NASA's Stratospheric Observatory for Infrared Astronomy (SOFIA). SOFIA is the world's largest and most advanced flying observatory, housed in a 747 aircraft with a retractable door that allows the telescope to view the infrared spectrum from the edge of the earth's atmosphere.
- Electrodynamics was awarded a contract to develop a new Crash Survivable Memory Unit for Saab's JAS-39 Gripen fighter aircraft for Sweden and other countries, including Hungary.
- Aviation Recorders' Hardened Voyage Recorder (HVR) received orders from maritime organizations, including Consilium, Japan Radio Corporation and Samsung, and orders for combination flight data and cockpit voice recorders as part of the US Coast Guard's Falcon upgrade initiative.

Specialized Products Segment

- L-3's Security and Detection Systems (S&DS) received two orders from the Transportation Security Administration (TSA) for a total of 425 eXaminer 3DX™ 6000 explosives detection systems.
- S&DS also received orders for thirteen VIS 108 in-line, automated Level 1 Explosives Detection Systems (EDS) from the airport authority of Spain, AENA (Aeropuertos Españoles y Navegación Aérea).
- S&DS received a blanket purchase agreement from the US Army for L-3's cargo products and an order for a mobile inspection system from Dutch customs for the Port of Rotterdam.
- Link Simulation and Training will provide two mission trainers and four weapons tactics trainers to Boeing for the next-generation F-22 stealth fighter aircraft and two F-16 Block 40L unit training devices for the Egyptian Air Force.

- Link also won contracts for full mission trainers, weapons tactic trainers and seat and canopy trainers to support F-22 Raptor pilot and maintenance training from Boeing.
- IEC won a contract to supply Global Positioning System (GPS) translators and GPS processors, engineering, logistics and field launch support for the Ground-based Midcourse Defense Segment (GMDS) awarded by the US Army's Strategic Missile Defense Command.
- Space and Navigation was awarded a contract by the United Space Alliance (USA) to upgrade the Integrated Electronics Assembly (IEA) used on the Space Shuttle's solid rocket booster.
- KDI Precision Products received continuing orders from the US Army and key weapon system prime contractors for Electronic Safety and Arming Devices for new artillery rocket, air-dropped bomb and air-to-surface missile precision weapon systems. In addition, KDI was awarded an international contract from Lockheed Martin and South Korea's Hyop Chin to transfer fuze technology from the Army's Multiple Launch Rocket System.
- BT Fuze Products' (BTF) electronic time fuzes were again ordered by the US Army as its primary solution for precision, high reliability electronic time fuzing for use with all fielded 105mm and 155mm artillery systems. BTF also teamed with Mecar SA of Belgium for wall-breaching tank ammunition for the US Army's Stryker Brigade Combat Team and has been awarded international fuze contracts from various companies, including BAE SYSTEMS of the United Kingdom and Denel SA of South Africa.

Photo above:

(l. to r.) Joseph Lopez, president of ILEX Systems Group, Dr. Jai N. Gupta, president of EER Group, Charles J. Schafer, senior vice president of business operations and president of Products Group, Steve Kantor, president of SPD Technologies Group, John S. Mega, corporate vice president and president of Microwave Group, Alan R. Dietrich, corporate vice president and president of Telemetry Group, and Joseph S. Paresi, vice president of product development and president of L-3 Security and Detection Systems division.

Photo below:

(l. to r.) Robert W. Drewes, corporate vice president and president of L-3 Integrated Systems, Curtis Brunson, corporate vice president and president of Communication Systems-West division, Gregory B. Roberts, corporate vice president and president of Communication Systems-East division, Anthony Caputo, corporate vice president and president of L-3 Communications Canada and James W. Dunn, president of Link Simulation and Training division.



- Randtron Antenna Systems (RAS) received contracts for the first low rate initial production lots of Cooperative Engagement Capability (CEC) antennas for the Navy's E-2C Hawkeye aircraft. The division also received initial funding for engineering analyses and risk reduction for the Adaptive Detection System (ADS). ADS provides the Advanced Hawkeye UHF radar antenna with electronic scanning features that offer significant improvements in radar coverage and identification capabilities at reduced weight.
- RAS is under contract to deliver UHF radar antennas and rotodomes to Northrop Grumman for installation on new production E-2C Hawkeye aircraft.
- Continuing its heritage in commanding equipment, Telemetry-West was awarded a contract to provide High Power Amplifiers (HPA) to Honeywell Technology Solutions, Inc. (HTSI) in support of the Air Force Satellite Control Network (AFSCN) contract.
- Storm Control Systems was selected by Shin Satellite of Bangkok, Thailand to supply the command and control software for the iPSTAR communications satellite. Under the contract, L-3 Storm will deliver a turnkey software suite, including its InControl-NextGeneration™ (InControl-NG) software, which will be used for all facets of iPSTAR satellite operations. Storm was also awarded an InControl-NG contract from Astrium of Europe to support Launch and Early Orbit Phase (LEOP) activities for Eurostar E3000 spacecraft operated by a variety of Astrium customers.
- ESSCO was awarded a contract to supply the ground-based radomes for the Space Lift Range Safety Contract (SLRSC) program. The SLRSC consists of assets to enable the safe and effective launch, testing and tracking for DoD, civil, commercial and international spacelift vehicles.
- L-3 Ocean Systems was awarded a production contract from Italy's Galileo Avionica to supply its Helicopter Long Range Active Sonars (HELRAS) to the European four-nation NH-90 helicopter program.
- SPD Technologies will provide power conversion hardware for use on the US Navy's LPD-17 vessels.
- L-3 Henschel is providing ship control consoles upgraded with integrated bridge system functionality to Bath Iron Works as part of a DDG-51 ship class upgrade program.
- MCII Electric, a division of L-3 Westwood, is completing a four-year requirements contract for 30 and 60 kW Tactical Quiet Generators used by all the US armed services for portable prime power.
- L-3 Satellite Networks was awarded contracts for portable Flyaway Tri-Band Satellite Terminals (FTSAT), Single Hub Terminal version of the FTSAT in transit cases and the Quad-Band Dual Hub Satellite Terminal/High Mobility Multipurpose Wheeled Vehicle System.
- Ruggedized Command and Control Solutions' (RCCS) Portable User Data Terminal (PUDT) was selected for use by the UK Bowman program. The PUDT is a specially ruggedized PDA, offering a half-sized VGA display (640 x 240 pixels) and the ability to enable multiple applications using various customer-determined PCMCIA devices. It also supports a wide array of battlefield applications where size, weight and extreme environmental protection are vital factors.

Acquisitions

During 2002, L-3 acquired businesses for an aggregate purchase price of \$1,703.2 million. The acquisitions added critical components to L-3's capabilities. These acquisitions are either number-one or number-two in their niche markets, have strong customer relationships, solid management, excellent engineering and a strong employee base. Just as important, they have an even brighter future as members of the L-3 family because they can now draw from our expertise regarding DoD mandates, substantial R&D resources as well as an international marketing force. Our more significant 2002 acquisitions include:

- **Raytheon's Aircraft Integration Systems (AIS)**, now known as L-3 Integrated Systems, a leader in the global ISR market and Communications Intelligence (COMINT), Signals Intelligence (SIGINT) and unique sensors for DoD and allied intelligence organizations.
- **ComCept, Inc.**, a leader in NCW capabilities, including requirements development, modeling, simulation, communications and systems development and integration for ISR.
- **PerkinElmer's Detection Systems**, now part of Security and Detection Systems, offers both automated and TSA-certified screening solutions, conventional X-ray systems and a complete range of cargo screening solutions, from rapidly deployable mobile systems to high throughput, high penetration fixed systems.
- **Wescam**, a leader in airborne EO/IR sensors and wireless visual information systems that capture images from mobile platforms and transmit them in real time to tactical command centers for interpretation and for commercial broadcast applications.
- Two businesses from Northrop Grumman: **Electron Devices**, a worldwide supplier of microwave power devices for key military programs and **Displays-Navigation Systems-San Diego**, now known as **Ruggedized Command and Control Solutions (RCCS)**, a world leader in ruggedized displays, computers and electronic systems for military and commercial applications.
- **Technology, Management and Analysis Corporation (TMA)**, a provider of high quality professional services to the DoD.

- **Westwood Corporation**, a leader in shipboard power control, switchgear and power distribution systems.
- **International Microwave Corporation (IMC)**, a provider of sophisticated sensors and command, control and communications technology for a number of customers, including the Immigration and Naturalization Service's (INS) Border Patrol.
- **Ship Analytics**, a producer of the CRISIS™ Management System, providing command and control for homeland security applications. The company also designs, manufactures and operates real-time simulation systems for critical shipboard operations.

Additionally, in January 2003, we signed an agreement to acquire **Goodrich Avionics Systems**, which develops and produces state-of-the-art avionics products and systems principally for the general aviation sector and for military platforms, such as Joint Primary Air Training System (JPATS).

Next-Generation Products

Central to L-3's growth is the ability to anticipate and create new products for the US military's modernization of existing platforms and its transformation efforts in the next several years. That process begins with working closely with customers and responding to their requirements and is augmented by alignment with mandates from the DoD. The following is a sample of L-3's new products:

- **F-22 Pilot/Maintenance Training Devices** from Link Simulation and Training. This device offers a full mission trainer, weapons tactics trainer and egress procedures trainer. This full mission trainer integrates a fully populated cockpit with a high-resolution image generation system that is coupled with Link's SimuSphere™ visual system display.
- **Secure Access System**, software and peripheral intelligent devices/sensors from Global Network Solutions. It provides secure access and monitoring of airports as well as other facilities, including parking lots. The system features search and analysis capabilities, including image recognition and peripheral intelligent devices with biometrics.
- **Military Airborne Surveillance System (MASS™)**, a new, enhanced Traffic Alert and Collision Avoidance System (TCAS) with capabilities of rendezvous and formation flying and the ACSS division's "Encroachment Alert" function. MASS has been selected by Boeing for the 767 Global Tanker Transport Aircraft (GTTA).
- The **FA2100-3053**, a solid state combined voice and data recorder with MIL-STD-1553 data input, providing two hours of voice and twenty-five hours of data storage; and the **Micro Quick Access Recorder**, developed for Flight Operations Quality Assurance (FOQA) initiatives with up to 800 hours for data collection, both from Aviation Recorders.
- The acquisition of RCCS brings a number of new products to L-3, including: the **Next Generation Handheld (NGH)** terminal unit, a rugged handheld computer designed for the digital battlefield or civil applications where durability is essential; the **Portable User Data Terminal (PUdT)**, which supports a wide array of battlefield or civil applications where size, weight and extreme environmental protection are vital factors; and the **MobileVu™**, a sunlight-readable color display and Pentium® computer system designed specifically for mobile use in law enforcement, fire, safety, utility, military and medical vehicles.
- L-3 Display Systems continued the development of the **PVI-600**, L-3's first commercial aviation display.
- Display Systems also introduced an innovative, rugged **micro-display system**, marking an important entry for L-3 into a new product area with the US Army. This high-resolution weapon-aiming display provides significant cost, weight and reliability improvements to the Javelin missile system Command Launch Unit by utilizing emerging new display technologies.
- **TheaterNet**, state-of-the-art communications system from Ocean Systems, providing over-the-horizon connectivity, high bandwidth and interoperable routing to multiple users in the military battlespace and augmenting existing air-land-sea-space communications systems.
- **PETRA System**, a key communications security component for the US government's High Assurance Remote Access (HARA), developed by Communication Systems-East and Kasten Chase. HARA provides users with secure dial-up networking, email and other data-related operations from remote locations.
- IEC has introduced a new **Selective Availability Anti-Spoofing Module (SAASM) upgrade kit** for its Global Positioning System Satellite Constellation Simulator (SCS) model 2450 for DoD, NATO and Japanese Defense Force applications.

- **Tactical Weapon Inertial Measurement Unit (IMU)** for precision-guided weapons, from L-3 Space and Navigation, uses Fiber Optic Gyro (FOG) technology for air-to-air missiles, air-to-ground precision-guided weapons and ground-launched munitions.
- Space and Navigation has finalized development of a **Compact Tactical Survey System** based on its successful Position and Navigation Unit (PNU). Dubbed "CATS," it provides a high-technology inertial solution to the military and commercial survey community for precise tactical positioning and emplacement of artillery, rocket, missile and mortar fires.
- **GPS Anti-Jam** for missiles, with a 120 dB suppression and high-performance jammer location capability from IEC.
- Also from IEC, **TruNav**, a compact integrated navigation unit combining a SAASM GPS receiver and a MEMS IMU.
- **Nardalert XT RF Personal Monitor**, the world's first monitor with data-logging and downloading capability, programmable control via PC and vibration alert. The product is designed to be worn by workers who risk exposure to harmful levels of radio frequency (RF) radiation, military personnel near radar and communications and industrial workers using RF heating equipment.
- **Avalon™**, a next-generation telemetry system from Telemetry-West that provides real-time telemetry and command processing capabilities for the US Air Force and classified satellite communities.
- Telemetry-West's state-of-the-art **Embedded National Tactical Receiver (ENTR)** is a robust receiver that packs the power of formerly rack-mounted receiver systems into a small, lightweight model, suitable for use in portable configurations in the field.
- Also from Telemetry-West, the **CXS-2000 Flexible Architecture Secure Transponder (FAST)**, a multi-purpose, high-performance Telemetry, Tracking & Control (TT&C) transponder for use on board high reliability satellites; and the **CTX-888 High Data Rate Transmitter**, an ultra high data rate transmitter for use on board remote sensing satellites.
- **Passive Millimeter Wavelength (mmWave) Imaging** portals and handheld screening devices for airports and facilities that reveal explosives, metals and plastics. Developed through a Millivision and L-3 partnership, these products are non-invasive and protect the privacy of individuals.

Commercial and Civil Opportunities

In 2002, the DHS began work on an extraordinary mission to protect US citizens and infrastructure from new threats of terrorism. This is a mission that will require a substantial dedication of resources and many years to complete. L-3 has a number of products for this market.

L-3's start in homeland security began in 1997 when the company agreed to adapt a computer tomography system used in medical technology to explosives detection for checked baggage. The eXaminer 3DX 6000, a Level 3 system, was the result of that product development effort and it was FAA-certified in 1998.

Since that time, L-3 has grown into a major player in a number of key security niche markets. With its acquisition of PerkinElmer's Detection Systems division and its existing explosives detection business, which comprises L-3 S&DS, L-3 is now the largest security screening company with the broadest product offering in the industry. The company provides automated and TSA-certified screening solutions in addition to conventional X-ray systems. S&DS also offers a complete range of cargo screening solutions, from rapidly deployable mobile systems to high throughput, high penetration fixed systems, delivered as turnkey products.

A major contract for L-3 has been the TSA's order to build 425 eXaminer 3DX 6000 systems to meet the US congressionally mandated deadline to provide screening of all checked baggage. In a singular achievement, L-3 was able to quickly meet the government's deadline to produce such a large quantity of machines in 2002. Currently, the company is working with major research universities to improve the speed and reduce the false-positive rates well beyond the TSA's requirements. L-3 S&DS is also working on new walkthrough and handheld scanners for use at airports, federal buildings and commercial facilities.

There are many other segments of the airport security product market that will provide growth opportunities to L-3. International demand for explosives detection systems will likely increase, along with an enhanced focus on advanced equipment for airport carry-on bags and walkthroughs, which do not monitor plastic explosives. The need for systems to inspect bulk cargo should also increase.

Many federal, state and local agencies are upgrading their crisis planning and readiness procedures for terror-

ist threats. The INS Border Patrol is utilizing L-3 International Microwave Corporation's (IMC) sophisticated sensors and command, control and communications technology to guard the nation's northern and southern borders. L-3 EER's intrusion detection system, used to guard Air Force installations around the world, is currently being applied to the civil and commercial markets to protect national assets, buildings and facilities.

L-3's MPRI division is offering crisis management to state and federal agencies at the forefront of homeland security preparation, such as the South Carolina Emergency Management Division and the EPA in Dallas, TX. In addition, L-3 Ship Analytics provides maritime and crane simulations to assist the US Coast Guard institutional education programs and port operations.

Growth in 2003 and Beyond

For the future, the US government and military are faced with a number of daunting challenges. Given the new world realities, how will US military forces be restructured to respond to these threats? What new platforms will be approved, how will the military transform its way of fighting and how much will it cost the DoD? What level of investment in the military can the nation afford given the requirement to fund pressing social needs? Just as important, is the US faced with a second Cold War...terrorism?

We believe there will be funding to support those weapons and tactics that proved so successful in the Gulf War and in the war in Afghanistan. There will likely be support for more mobile, lethal forces in each branch of the military that will quickly work together to surprise and overwhelm the enemy; expanded use of UAVs, Unmanned Combat Aerial Vehicles (UCAV) and Unmanned Ground Vehicles (UGV); integration of all ISR data so warfighters can respond in real time to threats; smarter, more precise weaponry; and missile defense.

The fiscal 2003 overall DoD budget of almost \$364 billion, including procurement and research, development, testing and engineering (RDT&E) funding of about \$127 billion, provides a solid base for the military and the defense industry to begin this transformation. In 2004, we expect social needs to command a larger share of the US budget. However, we also believe that the overall defense budget will still continue to grow by 4% to 5%, procurement and RDT&E will increase up to 7% from 2003 levels and that pace should continue over the next several years.

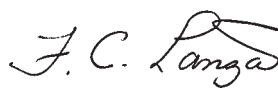
These budget trends are expected to be very positive for L-3's continued growth. L-3 has leading positions in the areas that will receive significant funding – ISR for manned and unmanned vehicles, secure communications, GPS and fuzes for precision weapons.

Homeland security should be another major growth area for L-3. The new DHS brings together 22 different government agencies and has a \$38 billion budget in 2003 with a focus on several priorities: first responder, WMD preparedness, border security, fusion of information and intelligence and emergency management for crisis response and consequence management. L-3 provides a number of products and services for those priorities and we believe that the DHS budget will increase in 2004.

DoD and homeland security budget trends offer a significant opportunity for L-3 to attain its goal of 20% sales growth in 2003, including organic growth and acquisitions. Beyond 2003, we believe that we will continue to achieve our annual organic sales growth objective of 8% to 10% and that the acquisition pipeline will continue to be ample enough to sustain our goal of a minimum of 10% to 12% annual growth through acquisitions. There are hundreds of small, privately held defense companies that need the marketing and R&D support of a much larger organization to facilitate their growth. There are also assets of large defense companies that will likely appear on the market as these firms continue to divest non-core businesses.

L-3 was the first company to outline consolidating the vendor base as a corporate growth strategy. It helps L-3 because it enables the company to broaden and deepen its offerings to the defense sector, which benefits greatly from these efficiencies. This strategy also helps the DoD because it ensures the survival and success of these small, innovative companies' capabilities for another generation.

We expect L-3's future prospects to continue to be excellent. We are well positioned to respond to the military's transformation requirements with our work in NCW, secure communications and precision weaponry and our nation's homeland security requirements. In addition, we have a singularly dedicated and talented workforce focused on driving product quality and innovation, a management team determined to achieve growth and continued efficiencies and a well-honed strategic plan to expand our businesses in areas of DoD spending growth in the years to come. For all these reasons, we believe that for 2003 and beyond, all the conditions are in place for L-3 to continue to grow and prosper.



Frank C. Lanza
Chairman and Chief Executive Officer



Robert V. LaPenta
President and Chief Financial Officer



Network-Centric Warfare

As the predominant military data communications company, L-3 Communications provides wideband, network-centric interoperability theater wide. L-3's data links, used for command, control and communications, have been selected for every major UAV platform, including (left to right) Global Hawk, Shadow and Predator.



- Intelligence, Surveillance and Reconnaissance (ISR)
- Network-Centric Collaborative Targeting (NCCT)
- Secure Communications



communications

NETWORK-CENTRIC

WARFARE

At the core of NCW is Intelligence, Surveillance and Reconnaissance (ISR). Providing real-time intelligence, surveillance and analysis on fixed and time-critical targets to the warfighter, these national assets are the eyes and ears of the battlefield and give the information dominance needed to improve the cycle time to “find, fix, track, target, engage and assess” any of the new threats that now face the US.



As the DoD prepares to fight 21st century adversaries, a key component of its transformation is fully realizing the potential of NCW. This form of engagement allows real-time availability of all information resident on platforms, weapons systems and sensors on a network-centric grid that can be shared by warfighters.

At the core of NCW is Intelligence, Surveillance and Reconnaissance (ISR). Providing both real-time information and analysis from a collection of ISR assets to warfighters will give them the information dominance needed to improve the cycle time to “find, fix, track, target, engage and assess” any of the new threats that now face the US.

The need for worldwide ISR has been driven by the fact that in 1999 half of the foreign crises demanding US attention occurred in “lower-priority areas” (John B. Gannon, quoted in “Time for a Rethink,” *Economist*, April 20-26, 2002). The US is no longer protected by distance. Therefore, both rogue nations and non-state entities can threaten the US and its allied citizens and interests with acts of terrorism and WMD from anywhere in the world.

Capabilities-Based Military

To counter these threats, ISR systems will have to progress from Cold War legacy platform-centric systems to network-centric capabilities. To be fully network-centric, systems will require a worldwide perspective, data fusion, greater detail and persistent surveillance.

Processes such as correlation, fusion and analysis will be key enablers for the warfighter to possess a single,

coherent picture of the area of interest. In the past, data has been kept in separate communications channels and databases using different bandwidths and technology. This information has been received from a multitude of sources, active and passive sensors, to include Electronic Intelligence (ELINT), Human Intelligence (HUMINT), Signals Intelligence (SIGINT), Imagery Intelligence (IMINT), Measurement and Signatures Intelligence (MASINT), Synthetic Aperture Radar (SAR) and Airborne/Ground Moving Target Indicator (AMTI/GMTI) radar.

Warfighters also require greater detail as adversaries base their operations in cities or in cavernous, mountainous regions. In addition, information must be precise to ensure that targeting data is within a few feet of the objective’s location, minimizing collateral damage and ensuring that when a weapon is deployed, the target is effectively destroyed.

Persistent ISR is also a necessity. During and after Operation Enduring Freedom, US forces obtained immediate information on the movement of enemy forces and destroyed them within minutes as they fled through Afghanistan and Pakistan.

Each of the armed services is working on efforts to increase interoperability through doctrinal and acquisition changes to meet these requirements, correlating multiple sources of ISR data and accelerating the process of getting it to the warfighter. The Army is writing a new doctrine for its Stryker Brigades and Future Combat Systems. The Navy’s primary effort is its Cooperative Engagement Capability for air and missile defense and the Navy and Marine Corps Intranet (NMCI).

As the largest military provider of ISR, the Air Force also has assumed a new role as the DoD’s executive agent for space, charged with coordinating the use of ISR in space. The Air Force has also formed a new office — the deputy chief of staff for warfare integration — ensuring that all Air Force systems fit into a common architecture. The emphasis will be on command and control and ISR systems.

Network-Centric Collaborative Targeting

One of the greatest challenges of NCW will be creating a system that quickly identifies, communicates and targets the enemy. Many opponents know that their fixed assets are vulnerable to US attack; increasingly they are relying

photos left:

Multi-Purpose Command and Control Aircraft (MC2A): The MC2A will provide next-generation Ground Moving Target Indicator (GMTI) capabilities on a 767-400ER with an integrated Battle Management Command and Control (BMC2) suite providing airborne battle management capabilities. MC2A will be the airborne hub for the C2 Constellation.

photo right:

RC-135 Rivet Joint: L-3 Integrated Systems’ (IS) Greenville operation has been modifying and servicing a special-mission surveillance fleet for the USAF for over 40 years. L-3 IS designed, built, integrated and installed some of the most sophisticated electronic surveillance equipment ever developed to assist warfighters and commanders before, during and after combat.

on ground mobility, transportable surface-to-surface missiles and rockets, mobile air defense systems and mobile command, control and communications systems.

These developments have led the US to work on creating a system that allows multiple sensors, weapons and C³I nodes to communicate over networks to target precisely and to engage moving or mobile threats. Network-Centric Collaborative Targeting (NCCT) is the US Air Force's initial thrust in this effort. NCCT is part of the Air Force's Multi-sensor Command and Control Aircraft (MC2A) program's Battle Management Command and Control (BMC2).

L-3 ComCept, which has a prime contract with the Air Force Office of Special Projects as part of the Big Safari program, has developed a key enabler to allow machine-to-machine fusion of intelligence from several aircraft, isolating mobile targets within minutes. L-3 ComCept

has been able to correlate data from the Rivet Joint, E-3 AWACS, E-8 Joint-STARS and Army Guardrail to synthesize new information. In the future, additional platforms are expected to be added, including the Royal Air Force's Nimrod, the US Air Force Distributed Common Ground Station, U-2, Global Hawk and others. L-3 ComCept's NCCT has been designed to fit easily into existing and next-generation aircraft.

The NCCT system provides a substantial cost savings for the Air Force. It could be established for 10% to 15% of the cost of a major sensor upgrade with significant improvement in data quality. An NCCT field capability could be online in 2007.

NCCT: Network-Centric Collaborative Targeting is a transformational joint and coalition capability designed to horizontally integrate multi-intelligence air, space and surface ISR assets. Using machine-to-machine interfaces, NCCT dramatically reduces the time required to detect, identify, locate and designate time sensitive targets. NCCT leverages existing sensor and communication systems and is a key enabling technology for the Command and Control (C2) Constellation.





MH-60: L-3 Integrated Systems provides comprehensive logistics support operations and maintenance to the US Special Operations Command, including maintenance and modernization of the MH-60 and other rotary-wing aircraft.

C⁴ISR

Along with developing the software architecture for transformational programs, L-3 Communications is an incumbent on every major C⁴ISR program. Specifically, L-3 IS provides products and services to the global ISR market, with a focus on SIGINT and COMINT to collect and analyze unknown electronic signals from command centers, communication nodes and air defense systems, giving the warfighter real-time situational awareness.

In addition, L-3 manages key specialized reconnaissance and surveillance assets for the Air Force and the SOF. The company offers fleet management and support, including procurement, systems integration, sensor development, modifications and maintenance for SIGINT and ISR special mission aircraft and airborne surveillance systems. Some key platforms include the RC-135, E-6B, U-2, Compass Call, P-3, MC-130H, EP-3E, ASTOR, Speckled Trout, MH-60K, MH-47E, MH-53E and AIMH-6. The RC-135 Rivet Joint was modified recently to respond to its expanded role in NCW as a key element in the DoD's effort to fuse ISR to tactical commanders on the battlefield.

Thirty years ago, the Rivet Joint intercepted enemy radio communications for national intelligence agencies. Today, the Rivet Joint's role is tactical, providing interception and integrating electronic attack capabilities from other aircraft, offering rapidly fused intelligence from several sources for handoff to key decision-makers.

MP-CDL

Data communications is another of L-3's key capabilities and it will be at the heart of NCW, enabling various platforms to share information. The company provides the data communications for the U-2, Big Safari, Guardrail, Global Hawk, Predator, Shadow, Fire Scout, S-3, F-16 TAR, F-18 ATAR and JSTARS.

The future of NCW data links is the Multi-Platform Common Data Link (MP-CDL) program. This Air Force program will provide affordable, operationally effective Line-of-Sight (LOS), wideband, air-to-air and air-to-ground, point-point and point-multipoint connectivity in a networked environment. MP-CDL will be part of an overall plan to migrate the Common Data Link family to network-centric connectivity. It will be closely tied to the Multi-Platform Radar Technology Improvement Program (MP-RTIP), Joint Surveillance Target Attack Radar System (JSTARS), Distributed Common Ground Station-Army (DCGS-A) and Global Hawk programs.



ASTOR: The UK Airborne Stand-Off Radar (ASTOR) program provides a SAR/MTI ground surveillance capability. L-3 Integrated Systems in Greenville, Texas is the system integrator for the ASTOR program. The first ASTOR aircraft will be configured and tested by L-3 IS.

The Air Force Aeronautical Systems Command (ASC) awarded L-3 Communication Systems-West the MP-CDL contract, along with team members Cubic, Inc. for surface terminal antenna design and Cisco for their networking expertise. L-3 will provide the network-centric wideband communication architecture that connects the critical information flow within the ISR community, regardless of platform or branch of service. The company's solution is based on next-generation dual data link concepts and common module developments.

Secure Communications

Another key initiative for the DoD transformation priorities is the Family of Advanced Beyond Line-of-Sight Terminals (FAB-T). The DoD would like these terminals designed as an open system with an architecture that is modular, reconfigurable, scalable and upgradable. Today's military commanders use satellite communications for combat systems; and for each satellite communications link, there is a single radio system and a special-purpose antenna for information exchanges among ground, airborne and space platforms.

L-3 Communication Systems-West is part of Boeing's team developing these wideband satellite communications terminals. L-3 will be responsible for the high-performance modem, baseband and networking interfaces, including the CPU, which will run the Advanced Extremely High Frequency (AEHF) protocols. The modem and baseband sections are fully programmable and will enable users to access all identified satellite systems, thus providing the capability to interact with and manage command and control networks, intelligence dissemination, mission data and target/threat updates.

In the end, the FAB-T program activity will eventually encompass up to 42 airborne platforms with participation from all armed services. It also secures L-3's modem and networking technology well into the future.

Information security will be another key component as joint US military and allied coalition forces plan their operations. L-3 Communication Systems-East and L-3 Telemetry-West are teaming with Boeing and Rainbow Mykotronx on the replacement to the existing MILSTAR system for the Advanced Extremely High Frequency (AEHF) Communications Security (COMSEC) and Transmission Security (TRANSEC) system, known in the industry as ACTS.

The original contract for new Crypto-Modern security components was awarded in 1999 and L-3 will deliver its products in 2004 for the 2006 launch of the first of three AEHF satellites. In January of 2003, there was a contract modification to provide the flexibility for future needs as they evolve. For this project, L-3 will supply a satellite COMSEC/TRANSEC component, a common Ground/Shipboard/Airborne COMSEC/TRANSEC component, a User Application Software component and specialized test equipment.

L-3 Communication Systems-East's Secure Terminal Equipment (STE) has evolved with product enhancements that meet the needs of our US military and government users. There have been five software upgrades, enabling interoperability between STE and secure wireless products, higher data rates for secure data communication and videoconferencing. In 2002, STE added the capability of a secure bridge for conference calls of up to 40 users. In addition, L-3 has expanded the secure terminal product line to meet customer requirements by adding the OMNI unit. The OMNI complements STE by providing a portable, low cost encryptor that connects to a standard analog phone to add Type 1 voice and data security.

STE: L-3's Secure Terminal Equipment (STE) supports secure voice and data communications by US troops in the Joint Operations Center at Qatar.





1



2



Transformation & Modernization

1. The Next Generation Handheld (NGH) terminal unit is the first fully V3 terminal that includes both Pentium® processing power and full sunlight readability. **2.** The Wescam MX-20 is the most advanced gyrostabilized airborne turret in the world, providing outstanding EO and IR images for extremely long-range covert surveillance and reconnaissance on the US Navy P-3 and the US Coast Guard C-130 Hercules. **3.** Satellite Networks' Quad-Band Dual Hub Satellite Terminal (QDHT) provides a cost-effective solution for mobile GMF-compatible SATCOM terminals. The dual hub configuration supports up to twelve spokes and data rates up to 20 Mbps. **4.** L-3 Communications' Tactical Common Data Links provide battlefield commanders with real-time, secure surveillance and targeting information. L-3's strategic and tactical data links and Common Data Link (CDL) systems are considered DoD standards for data link hardware.



- Transformation
- Modernization
- Precision Weaponry
- Missile Defense



communications



TRANSFORMATION &

MODERNIZATION

There is no single transformation element or silver bullet. Instead, there will be a series of transformations with comprehensive results within this decade... there will be a greater reliance on precision, surveillance, network communications, unmanned vehicles for air, land and sea and information processing.



For the DoD, transformation is much more than the selection of certain advanced aircraft, ships or weapons. Preparing for the future requires a different strategy — different forces, different capabilities and a different way of thinking. It involves cultural change within the military and the defense industrial base and a shift to a series of capabilities to defend against a myriad of global threats. The US has to be prepared to adapt to an ever-evolving set of challenges and circumstances to deter and defeat threats and adversaries.

After the events of September 11th, it is clear that it will be difficult to predict who will threaten the US and when and where the threats will emerge. However, the capabilities the US will need are clear.

There is no single transformation element or silver bullet. Instead, there will be a series of transformations with comprehensive results during this decade. As outlined in the US 2001 Quadrennial Defense Review (QDR), there will be a greater reliance on precision, surveillance, network communications, unmanned vehicles for air, land and sea and information processing.

Over time, US military forces will become more lethal and increasingly more mobile. They will quickly be inserted into engagements with assets that will be networked for a real-time view of the battlespace. Air, space, sea and land offer unique challenges and opportunities for our forces and industry.

The DoD will accelerate the development of missile defense. It will also procure fast transport ships to move rapidly into contested littoral areas. There will be unmanned underwater vehicles and more investment in unmanned aerial and combat vehicles. There will be a

space-based radar system for persistent ground surveillance and tracking. Secure communications and data transmissions will be a priority, along with funding for space and information technology developments.

Transformation will involve not just new technologies, but new ways of fighting. There will be a much greater reliance on joint forces, just as there was in the Afghanistan conflict.

Change will also take place in the way that the DoD procures its platforms and weapons. In the past, the government developed a set of requirements, which were often modified during the process, resulting in either delays or increased costs of platforms or weapons. Now the DoD will employ spiral development, which will focus on deploying equipment into the field with the understanding that additional enhancements will follow as they become available.

L-3 has a series of products and technologies that will assist US forces as they modernize and transform their platforms and warfighting strategies. L-3 Satellite Networks developed the Quad-Band Dual Hub Satellite Terminal (QDHT), a satellite communications terminal mounted on a High Mobility Multipurpose Wheeled Vehicle (HMMWV) that is intended to replace aging hub terminals used in Ground Mobile Forces (GMF) networks. The QDHT operates over government satellites at X- and Ka-bands and over commercial satellites at C- and Ku-bands.

L-3 Link Simulation and Training has developed a networked technology that will allow Army helicopter pilots and crews to train collectively as a unit for missions utilizing multiple platforms. The program is called the US Army's Aviation Combined Arms Tactical Trainer-Aviation Reconfigurable Manned Simulator (AVCATT-A). L-3 is now in the process of delivering these training systems, which are housed in semi-trailers that can be transported by land, air or sea to units in need of tactical training. These simulators offer highly realistic, high-intensity, virtual combat training and are interoperable with the Army's currently fielded combined arms trainers operated by the armored units.

L-3 EER, assisted by Link, will be developing the Navy's first F/A-18C Distributed Mission Training (DMT) system. This system is the first step in the Navy's extensive plan to implement training in a distributed environment, mirroring future operations that stress multi-unit, joint and

photos left:

P-3 Modernization: Royal Australian Air Force (RAAF) AP-3C Orion — L-3 IS is delivering one of the world's most capable maritime patrol aircraft to the RAAF under Project Sea Sentinel. The program aims to reduce weight and maintain mission effectiveness by replacing obsolete systems and sensors with state-of-the-art equipment that is lighter and more supportable.

photo right:

AVCATT-A: AVCATT-A's reconfigurable manned modules, simulating the Army's attack, reconnaissance and utility helicopters, will enable commanders to mix and match rotary wing platforms during training exercises conducted over a realistic, virtual battlefield.

coalition operations. The DMT suite will consist of four high-fidelity, networked trainers enabling pilots to train in tactical deployment as a division.

As the Army increases its focus on digitization of the battlefield, L-3 RCCS has created the Appliqué+V4 open architecture system for situational awareness, command and control and weapons targeting applications. This architecture can be hosted in a wide range of wheeled, tracked or airborne platforms. L-3's Manportable System is a next-generation handheld computer that will replace the 5,000 legacy computers used for mounted and dismounted applications. It has a modular design that can be upgraded with GPS, touch screen and other enhancements.

For the Navy, L-3 RCCS has developed next-generation displays that replace legacy systems. These products are smart, network-capable and have ultra-thin or thin client displays.

Modernization

The US campaign in Afghanistan was conducted by aircraft that have been in service for decades and the military has outlined the need to maintain the current fleet in warfighting condition for many more years. The DoD has committed to the implementation of a comprehensive modernization strategy that will add new technology and improve the capabilities of existing aircraft and weapon systems.

L-3 Integrated Systems is the most capable and dependable aircraft modernization and mission systems integration organization in the world, having modified more than 15,000 aircraft of more than 125 types.

HELTRAS: *The HELRAS sonar can detect submarine targets at far greater ranges than any dipping sonar in the world.*





Ruggedized Command and Control Displays: (left) Appliqué+V4 computer is a versatile, upgradable solution for situational awareness, command and control and weapons targeting applications designed to be hosted in a wide range of wheeled, tracked or airborne platforms and other demanding tactical applications.

(right) The Portable User Data Terminal (PUDT) is a specially ruggedized PDA, offering a half-sized VGA display and the ability to enable multiple applications using various customer-determined PCMCIA devices. Selected for use by the UK Bowman program, the PUDT easily supports a wide array of battlefield applications where size, weight and extreme environmental protection are vital factors.

L-3 Spar Aerospace provides aircraft maintenance, structural life extension, avionics systems modernization, mission systems upgrades and integrated logistics support services for military and commercial aircraft, including the Lockheed Martin C-130 Hercules military transport and Boeing 737/727. Spar also performs component maintenance, repair and overhaul on Sikorsky S-61/H-3 helicopter dynamic components, as well as a number of fixed-wing aircraft cockpit instruments and engine accessories. Major customers include the Canadian Department of National Defense, US Navy, US Coast Guard, Hellenic Air Force, Royal Malaysian Air Force, Brazilian Navy, Mexican Air Force and Royal Australian Air Force. In 2002, Spar signed a contract with the Hellenic Air Force (HAF) to upgrade its fleet of fifteen C-130 aircraft. Spar was also awarded an ongoing depot level maintenance contract to support nine USCG C-130 aircraft over an 18-month period. Spar is currently nearing completion of the design and prototype of a fuselage and wing structural upgrade and rewiring package for the Canadian Air Force's C-130 fleet.

L-3 Ocean Systems, a worldwide supplier of acoustic undersea warfare systems, has introduced Tsunami™, a revolutionary, active long-range Anti-Submarine Warfare

(ASW) sonar. This sonar substantially reduces the size, weight and complexity of conventional sonars. Tsunami's functions include active and passive ASW, obstacle and mine avoidance, active and passive torpedo alert and interoperability with existing mid-frequency systems.

Ocean Systems also manufactures the Helicopter Long Range Active Sonar (HELTRAS), the highest performing helicopter dipping sonar in the world, featuring long-range deep and shallow water surveillance capability, even against quiet, stealthy diesel electric submarines. The long-range performance of HELTRAS offers a far better defense against today's modern diesel electric threats and gives the theater commander the flexibility to use sonar in a wide-area surveillance role.

Towed array technology has advanced rapidly with longer range systems that have an increasing number of sensors for submarine-based ASW. In 2002, Ocean Systems delivered its first two TB-29A towed arrays while working under contract with Lockheed Martin Integrated Systems on the Omnibus program. These arrays will be used to back-fit Los Angeles (SSN-688 and SSN-688I) class submarines and forward-fit the Virginia (SSN-774) class and will be deployed on the Seawolf and the nuclear-powered attack submarine (NSSN).



TruTrak: (left) L-3's TruTrak Locator GPS receiver is now being integrated into all US Air Force Combat Survivor Evader Locator (CSEL) radios.

Compact Tactical Survey System (CATS): (right) L-3 Space and Navigation's CATS provides a high-technology inertial solution to the military and commercial survey community for precise tactical positioning and emplacement of artillery, rocket, missile and mortar fires.

Precision Weaponry

In the future, US warfighting strategy will involve such transformational capabilities as increased accuracy, rapid deployability and the use of air- and indirect artillery-delivered precision munitions. Precision weaponry allows the military to attack targets with fewer rounds expended and defeat a target with reduced collateral damage. The DoD has made it a priority to accelerate a variety of precision munitions, including GPS-guided rounds, such as the Army's Excalibur program and the Air Force Wind Corrected Munitions Dispenser (WCMD) program. The DoD would also like to add GPS guidance and accuracy to upgraded Multiple Launch Rocket System (MLRS) and High Mobility Artillery Rocket System (HIMARS) vehicles.

L-3 IEC, an industry leader in GPS receiver and translator-based products, was one of five companies presented *Aviation Week's Technology of the Year* award for the design and development of a GPS projectile receiver that can withstand 15,500 g's when launched from an artillery platform.

In 2002, L-3 IEC started production of its TruTrak Locator Handheld GPS receiver and is under contract with Boeing to supply this receiver for the US Air Force Combat Survivor Evader Locator (CSEL) program. This SAASM GPS receiver is designed for the CSEL downed pilot rescue radio. The heart of it is the XFACTOR Selective Availability Anti-Spoofing Module. In 2002, IEC was the first company granted full security approval by the US government to start production and the sale of

these next-generation SAASM GPS receivers to both US and NATO military platform users.

IEC has also developed a Fast Acquisition Correlator chip, which is part of its own XFACTOR SAASM multi-chip module. This is the fastest chip of its kind in the industry and gives the SAASM the ability to acquire a GPS signal in less than three seconds — making it ideal for smart weapons, such as artillery rounds and projectiles.

In addition, L-3 Space and Navigation (S&N) has finalized development of the CATS system. CATS expands S&N's high-performance inertial product offering into new customer bases and applications, both foreign and domestic.

L-3 is a leader in providing fuzing products and Electronic Safety and Arming Devices (ESAD) to military forces on every continent. KDI was selected to develop and qualify an ESAD for Boeing's Small Diameter Precision Guided Bomb program. The division was also selected by Lockheed Martin to develop and qualify an ESAD and a low cost, jam-resistant height of burst sensor for the unitary warhead variant of the Army's Guided Multiple Launch Rocket System (GMLRS). L-3 Electroynamics has enhanced its ESAD product family to provide fuzing capability for the French Crotale air defense system and the US Army Mongoose mine-breaching program.

L-3's BT Fuze Products (BTF) reached a milestone with the production of its 500,000th M762/M767 artillery fuze for the US government. BTF also teamed with Mecar of Belgium to provide wall-breaching 105mm tank ammunition to the US Army for its new Brigade Combat Team tank system. During the past year, BTF has entered into several teaming agreements with major weapons prime contractors to provide ordnance fuzing and technology support for various future weapons systems to include a precision-guided mortar, course-correcting artillery projectiles and two new guided rocket systems.

Also on the precision munitions front, L-3's Telemetry-East division was awarded a letter subcontract from Raytheon Missile Systems for the Excalibur Tactical Telemetry System (XM-982). The initial contract covers the design and development phase of the XM-982 guided artillery projectile, which also features L-3 GPS and IMU guidance, with subsequent contracts to be issued for the low rate initial production phase. The award positions L-3 as the prime supplier of telemetry systems for future precision-guided munitions programs.

Missile Defense

The DoD has outlined its plans for missile defense research and testing over the next few years. The current goal is a multi-layered anti-missile system that includes land-based interceptors at Fort Greely and Vandenberg Air Force Base (AFB) in 2004-2005. These interceptors would consist of giant booster rockets designed to soar into space carrying "kill vehicles" programmed to identify long-range enemy warheads and obliterate them by the sheer force of collision.

As many as 20 smaller interceptors would be placed on three Navy ships for use against short- and medium-range missiles. To detect and track enemy missiles, the DoD proposes building a high-resolution X-band radar that will be placed at sea and a new system of space satellites known as SBIRS-High as well as employing Navy ships equipped with Aegis defense systems and SPY-1 radars.

In 2002, IEC delivered GPS Translator Processor (GTP) systems to the Vandenberg AFB Tracking Range Site (VTRS). This GPS-based tracking system is now common to the US Navy Trident Submarine Missile Launch Test program as well as the US Missile Defense Agency

(MDA) programs — Ground-based Midcourse Defense Segment (GMDS) and Theater High Altitude Area Defense (THAAD). These deliveries complete the tracking coverage area for the Western range by linking the area with GTP ground stations previously installed at the Reagan Test Site (RTS) at Kwajalein Atoll and other outlying islands in the Pacific Ocean.

The airborne components for these tests are the Digital GPS Translators (DGT), which were flown on the kill vehicle boosters and the targets for the GMDS and THAAD tests. Two full-scale tests of the GMDS program were supported in 2002. One was held in March and another in December and both provided the precise tracking accuracy required for these long-range tests through the combined use of the airborne and ground station equipment. Communication Systems-East is providing a Ka-band Solid State Power Amplifier (SSPA) subsystem to Boeing for the GMD interceptor.

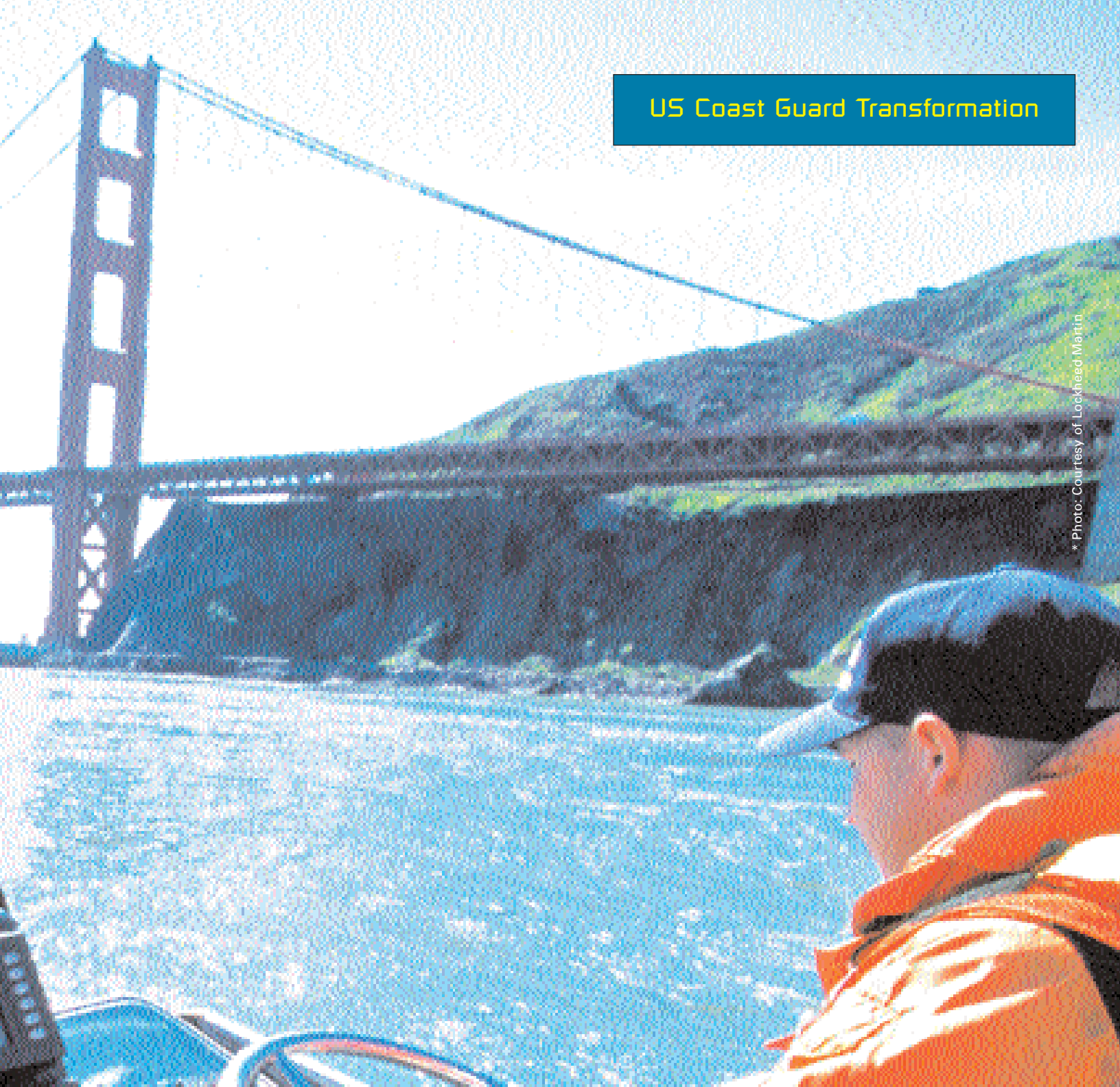
L-3 Communications merged Coleman Research with SY Technology to create a wholly owned subsidiary called SYColeman Corporation, which along with Coleman Aerospace, delivers tremendous capability to the missile defense sector. SYColeman won several programs, including the US Army Space and Missile Defense Command's SETAC Omnibus contract in Huntsville, AL.

Coleman Aerospace successfully launched another Hera target missile in support of the Patriot Advanced Capability for the MDA in 2002. The Hera Modified Ballistic Reentry Vehicle-3 (MBRV-3) target supported the Patriot Advanced Capability-3 (PAC-3) Operational Test/Developmental Test 1A (OT/DT-1A) mission, continuing L-3's tradition of successful target launches in support of the PAC-3 program. Coleman Aerospace also received a task order from the US Air Force Space and Missile Systems Center (SMC) for the MDA. This new task order provides for the second phase of the LRLT program, during which Coleman will complete the development and perform a demonstration mission of the LRLT system to support the Theater Missile Defense (TMD) program.



Homeland Security

Deepwater: L-3 won task orders for the US Coast Guard's Deepwater program for systems engineering and C'ISR architecture development, including preliminary design scope for initial assets. Assets consist of the National Security Cutter (NSC), the Fast Response Cutter (FRC), the Offshore Patrol Cutter (OPC) and various shore-based installations. L-3 also received funding to develop an integration and test facility in support of various US Coast Guard communications solutions.



US Coast Guard Transformation

* Photo: Courtesy of Lockheed Martin

- Airport Security
- Cargo Security
- Maritime and Port Security
- Intrusion Security
- Crisis Management



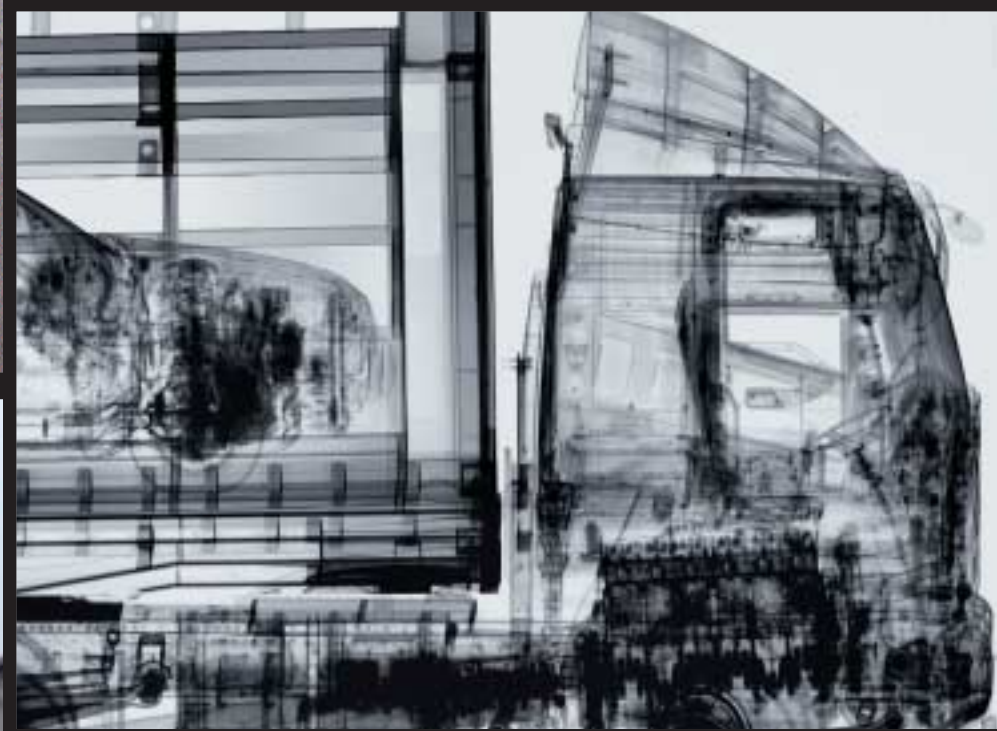
communications



HOMELAND

SECURITY

In 1997, L-3 developed a new generation of bomb detection for airports, which since September 11th, has become a major element of homeland security. Since then, L-3 has expanded its focus into many new product areas. In fact, L-3 has now become, with the addition of PerkinElmer's Detection Systems division, the largest solutions provider of X-ray screening systems in the world.



Global Threats

Defending the US against terrorism is a massive endeavor. Today, terrorist groups, rogue nations and criminal organizations can make or assemble weapons of mass destruction to threaten citizens and their way of life.

Predicting how, when, who and where they will strike is an almost impossible task, but it falls upon federal, state and local government officials and US allies to find ways to increase security wherever there is vulnerability.

In general, the mission involves protecting the public, preempting attack and managing crises. However, most current government, civil and commercial systems, with a few exceptions, have not been designed to respond to these emerging threats. In addition, the new DHS, under the direction of Cabinet Secretary Tom Ridge, is working to address these issues while at the same time facing the challenge of incorporating 22 agencies under its new purview. These agencies will analyze threats and intelligence, guard borders and airports, protect critical infrastructure and coordinate the response of the nation to future emergencies.

With the massive flow of people and goods crossing borders, terrorists, criminals, weapons and contraband can also enter the US. Each year, more than 500 million people from other countries cross US borders. There are 7,500 miles of border with Canada and Mexico and 95,000 miles of US coastline with 350 ports of entry. Over 11 million trucks and over 2.2 million rail cars cross into the US each year. The federal highway system alone includes over 10,000 bridges and tunnels.

A key priority of the DHS will be to establish and implement a seamless border of the future that protects air, land and sea and also enables legitimate goods and people

to travel freely. The department has already empowered the TSA to secure all modes of transportation. The DHS will create a state-of-the-art immigration and visa system using biometric technologies and shared governmental databases. Additionally, it has assumed responsibility for the US Coast Guard, which is charged with the safety and security of American harbors and waterways along with other missions.

Security Products

In 1997, L-3 was an early entry into the homeland security market with its initial development of a Level 3 Explosives Detection System (EDS) for airport checked baggage screening. Since then, L-3 has expanded its focus into many new product areas. L-3 formed S&DS with its heritage EDS business and PerkinElmer's Detection Systems business in 2002, and became the largest solutions provider of X-ray screening systems in the world.

In 2002, the TSA awarded L-3 a contract to supply 425 eXaminer 3DX 6000 systems to airports across the US in conjunction with the Administration's airport security efforts. In less than nine months, L-3 was able to increase its manufacturing output from only a few systems a month to nearly 50. Most of these systems have been distributed to airports across the country and installed by Boeing under the TSA's Explosives Detection Systems/Explosives Trace Detection (EDS/ETD) initiative.

In 2003, it is expected that the TSA will order additional systems to complete distribution of EDS systems to major US airports. It is also expected that the TSA will order L-3's certified ARGUS explosives detection product for smaller airports. As the TSA completes its supply requirement for US airports, the marketing for EDS systems will be focused on meeting international demand.

In the beginning of 2003, L-3 received its largest international award for both Level 1 and Level 3 systems from Singapore's Changi Airport. This contract was the first of its kind to encompass a single solution to security needs and reaffirms L-3 S&DS' strategy to be a complete provider.

S&DS is also focused on making technology advancements in its EDS performance. Currently, the company is working on improvements to its operational efficiency and throughput and plans to institute them in 2003. These upgrades will not only increase the speed and

photos left:

eXaminer 3DX 6000: The eXaminer 3DX 6000 is a TSA-certified, second-generation explosives detection system that meets the government's requirements for automatic explosives detection with a low rate of false alarms.

photo right:

Cargo: Cargo screening solutions have been engineered to meet the increased demands of homeland security including inspection for cargo, port, maritime and border screening as well as force protection. L-3's new mobile cargo X-ray system is capable of fully scanning parked vehicles in a single pass from a mere 40 centimeters above ground level to its full scanning height of 4.45 meters.

analysis capabilities of the EDS, they will reduce the labor costs to the government by relying less on an operator.

Also, in the future, it is expected that the US government will focus on upgrading the technology of its conventional carry-on luggage detection systems and passenger portals. Current systems in airports only check for metal weapons and not explosives. L-3 is working with Millivision to create systems and walkthroughs that will use passive millimeter wavelength technology to reveal the presence of explosives and non-metallic weapons without violating privacy or endangering health.

Another area of concern will be cargo inspection systems for air, land and sea transport. S&DS offers a full complement of cargo X-ray imaging products, including both fixed and relocatable systems. Its CX-2500M, for example, is a self-contained mobile unit that is capable of scanning trucks and shipping containers as it drives

alongside them, generating an X-ray image of the entire vehicle or container contents.

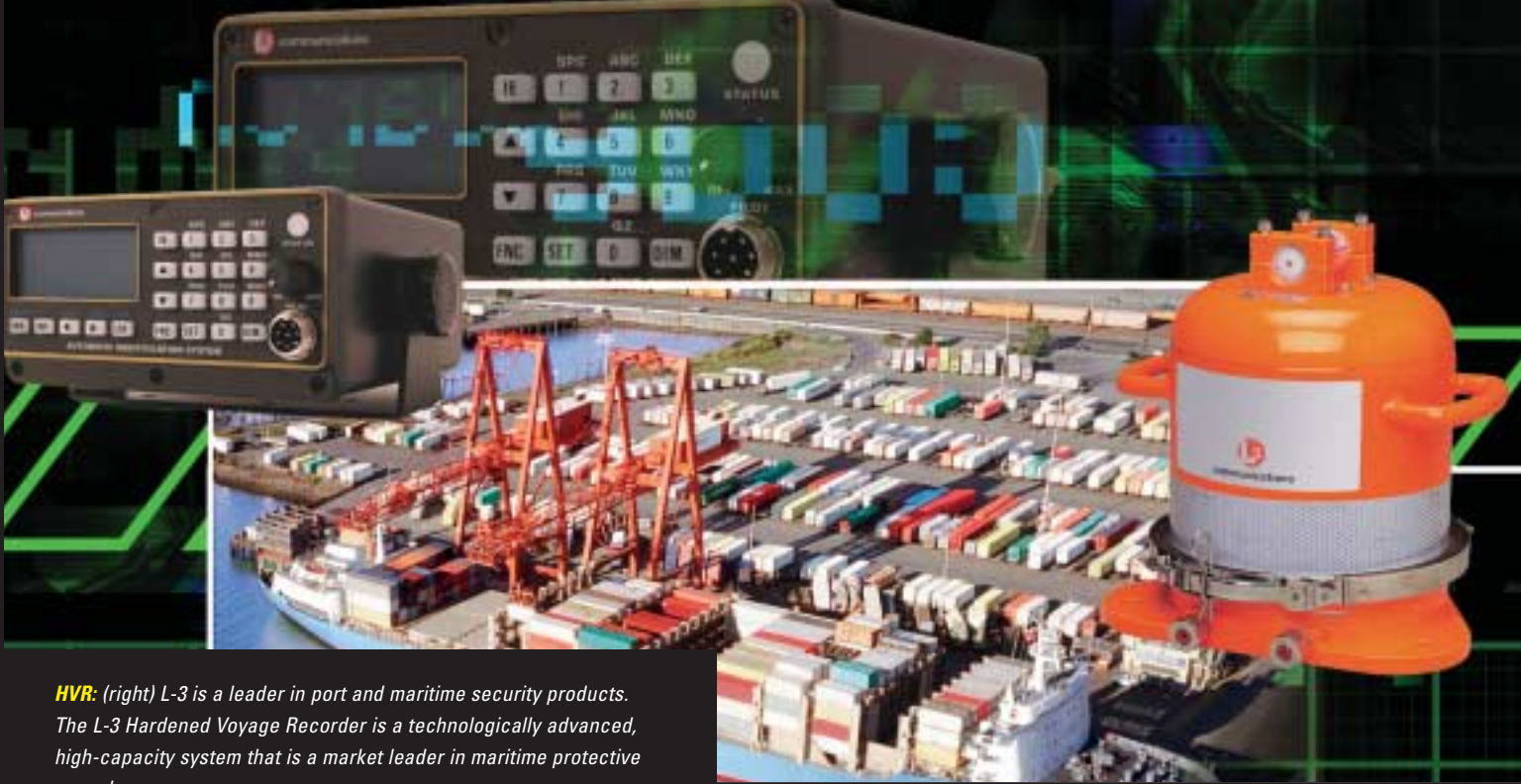
Aircraft and Maritime Safety and Security

In the commercial aviation market, L-3's T²CAS product is a true terrain avoidance system that bases its operator alerts on an aircraft's actual ability to climb at a given moment. This FAA-certified system has been selected by Northwest Airlines, Federal Express, Aeromexico, Virgin Express, Mesaba, Aero California and the US Customs Service. In addition, L-3 Display Systems manufactures the Pilot Vehicle Interface (PVI) Series 600 Multi-Function Display (MFD). This new PVI 600 MFD combines the

T²CAS: (right) The FAA-certified T²CAS is aviation's only combined terrain and traffic collision avoidance system.

PVI: (left) The Pilot Vehicle Interface (PVI) Series 600 Multi-Function Display (MFD) is L-3's new display product for the commercial aviation market. The MFD combines the functionality of traffic, terrain and weather radar on a single 3.9"x 5.2" screen, providing enhanced cockpit situational awareness.





HVR: (right) L-3 is a leader in port and maritime security products. The L-3 Hardened Voyage Recorder is a technologically advanced, high-capacity system that is a market leader in maritime protective capsules.

AIS: (left) Setting the standard in safety, navigation and communication technology, L-3 has developed a new line of Global Maritime Distress Safety System (GMDSS) products such as Automatic Identification Systems (AIS), GMDSS Base Stations and VHF Digital Selective Calling (DSC) Radios.

functionality of traffic, terrain and weather radar on a single 3.9" x 5.2" screen.

Working with L-3's ACSS, the PVI 600 MFD has been designed as the preferred display for the T-CAS system, providing enhanced cockpit situational awareness. This display is the first in a family of PVI display products for the commercial air transport community. The PVI 600 provides highly integrated and conductively cooled electronics, as well as the latest AMLCD technology, with growth options to meet FAA mandates.

The US Coast Guard's Integrated Deepwater System Program is the largest modernization program in its over 200-year history. The Coast Guard's fleet of sea and air platforms will have to be modernized to be able to handle the fourteen mandated missions in deepwater regions around the globe, including homeland security. As a result, the Coast Guard requires that its assets have the capability to detect, intercept and interdict potential threats on the high seas.

Under the Deepwater program, there will be three classes of new cutters and associated small boats, a new fixed-wing manned aircraft fleet, a combination of new and upgraded helicopters and both cutter-based and land-based UAVs. These assets will be loaded with C'ISR systems, along with an integrated logistics regime.

Numerous foreign nations have expressed an interest in participating in the Deepwater program. Their goal is to improve their own assets' interoperability with American maritime forces and coalition partnering. Some of the nations expressing interest are Norway, Brazil, Chile, Japan, Australia, Spain, Italy, Greece and South Africa.

Both Lockheed Martin and Northrop Grumman are part of the team that won the Deepwater contract. L-3 is on that team to provide communications equipment. In 2002, L-3 was awarded task orders from Lockheed Martin for systems engineering and C'ISR architecture development, preliminary design scope for initial assets, including the National Security Cutter (NSC), the Fast Response Cutter (FRC), the Offshore Patrol Cutter (OPC) and various shore-based installations. L-3 also received funding to develop an integration and test facility in support of various US Coast Guard communications solutions.

Ship safety and security are also a central priority for the IMO. Passenger ships and ships of 3,000 gross tonnage and upwards constructed after June 30, 2002 will soon be required to carry Voyage Data Recorders (VDR). Like "black boxes" for airplanes, VDRs enable accident investigators to review procedures and instructions in the moments before an incident to help identify the cause of an accident.

L-3's Aviation Recorders business produces the Hardened Voyage Recorder, which is compliant with IMO requirements. The HVR is a solid state, high-capacity system that provides over 12 hours of storage for radar, sensor and audio data within a protected memory capsule.



TASS: (left) L-3's EER Systems division provides the Air Force with integrated perimeter and area security systems to protect personnel and critical assets worldwide. Hundreds of long- and short-range sensors are currently deployed throughout Southwest Asia as part of the Tactical Automated Security System (TASS).

REMBASS-II: (right) REMBASS-II is a next-generation unattended ground sensor system used to detect and classify intruders. It is currently in use by military intelligence battalions in theater and has been successfully demonstrated for homeland security applications.

Also mandated by the IMO is the use of an Automatic Identification System (AIS), capable of providing information about a ship to appropriately equipped shore stations, other ships and aircraft. This shipboard collision avoidance and situational awareness system has many key features and will let the Coast Guard and local port authorities know a ship's current position, where it has come from, its destination and its manifest.

Aviation Recorders' AIS products, which include base stations and shipborne equipment, will improve situational awareness for bridge crews and will facilitate communications among vessels. The USCG and local port authorities currently use L-3's AIS equipment in major US ports, including New Orleans, Tampa Bay, Houston/Galveston and New York.

The IMO regulation requires AIS transponders to be fitted aboard all ships of 300 gross tonnage and upwards that are engaged on international voyages, cargo ships of 500 gross tonnage and upwards engaged on international voyages and passenger ships irrespective of size.

Protecting Infrastructure

The health and vitality of the US is driven by a number of key services, such as a quality water supply, energy and utility plants, the transportation network of food and goods, information technology, banking, telecommunications and public health. Any disruption in these operations could be catastrophic for US citizens and damaging to the economy.

Under the direction of Secretary Ridge, the DHS will coordinate a national effort among federal, state and local governments to secure America's critical infrastructure and commercial enterprises. Under this program, the DHS will also identify and assess each infrastructure sector using the best modeling and simulation tools to prioritize its preparation efforts. Then the DHS will direct or coordinate action to protect significant vulnerabilities, particularly targets with catastrophic potential, including nuclear power plants, chemical facilities, pipelines and ports.

L-3 is currently working with first responders and the National Guard in key states to provide both crisis management expertise and software products. The company conducts vulnerability and risk assessments, develops plans for disaster response, develops strategies to deter and defend against terrorist attacks and delivers simulation and training exercises to train decision-makers.

L-3's CRISIS Management System is a comprehensive program to support decision-makers and diverse organizations in responding to a variety of environmental and man-made disasters. The system uses sophisticated relational databases and Geographic Information System (GIS) techniques to enable geographically dispersed teams to manage coordinated responses to oil spills, floods, hurricanes, fires, toxic releases and acts of terror-

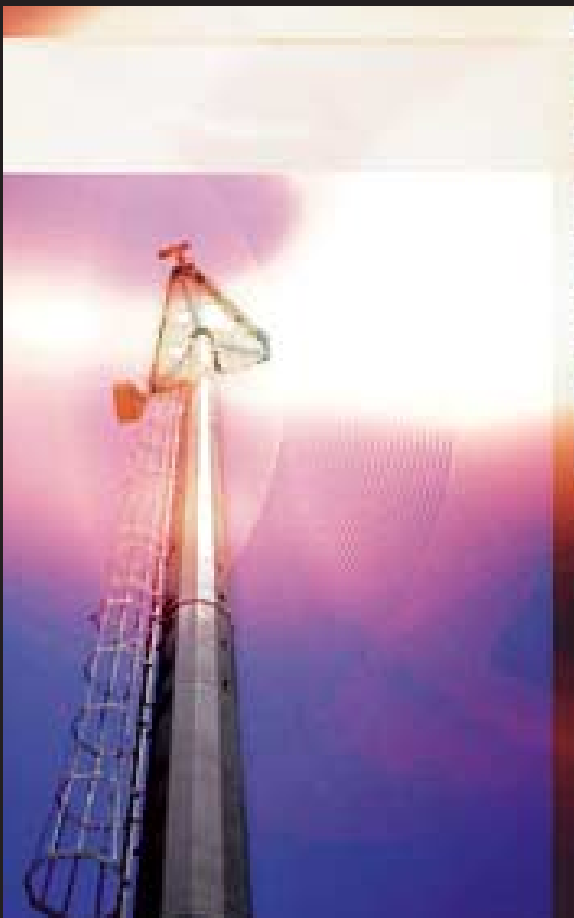
ism. It also utilizes embedded training capabilities to provide simulation enhanced training exercises and preparation for actual events, which can be objectively evaluated against approved/recommended standards and benchmarks.

To protect against border incursions, L-3's IMC business is assisting the INS and the US Border Patrol (USBP) in creating border security systems along the Canadian and Mexican borders. Under the government's Remote Video Surveillance (RVS) program, the company provides thermal imaging and CCTV cameras and associated control systems with microwave radio technology for long-range perimeter security systems.

To protect vital assets, including infrastructure elements and critical commercial facilities, L-3 EER offers its Tactical Automated Security System (TASS). This system has been used to protect vital military bases around the world and is now being offered to both civil and commercial markets. TASS is a rapidly deployable, easily transportable and quickly relocatable integrated electronic security system. The interoperable system integrates disparate sensors and legacy systems. Under a recently awarded contract from the Air Force, L-3 EER successfully demonstrated a broad range of state-of-the-art technologies that could be used to provide integrated security solutions for government-wide installations. Similarly, L-3 Communication Systems-East offers the Remotely Monitored Battlefield Sensor System (REMBASS-II), an award-winning suite of early warning remote access perimeter security sensors that has been successfully field tested for homeland security use from military applications.

Border Patrol: (left) L-3 IMC's WatchTower system assists the US Border Patrol as a force-multiplier in its mission to apprehend illegal aliens and contraband by providing the local USBP agents with a continuous view of the US border from a centrally located control room.

Crisis Management: (right) L-3 MPRI Senior Observer Controller conducts an After-Action Review following a "Force-on-Force" exercise involving US forces in Kuwait.







Financial Statements and Other Information

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Board of Directors:

(front l. to r.)

*Frank C. Lanza
Chairman and Chief Executive Officer*

*Robert V. LaPenta
President and Chief Financial Officer*

(back l. to r.)

General (Ret.) John M. Shalikashvili

Arthur L. Simon

Alan H. Washkowitz

John E. Montague

Robert B. Millard

Thomas A. Corcoran

Selected Financial Data

We derived the selected financial data presented below at December 31, 2002 and 2001 and for each of the three years in the period ended December 31, 2002 from our audited consolidated financial statements included elsewhere herein. We derived the selected financial data presented below for the years ended December 31, 1999 and 1998 and at December 31, 2000, 1999 and 1998 from our audited consolidated financial statements not included herein. You should read the selected financial data together with our "Management's Discussion and Analysis of Results of Operations and Financial Condition" and our audited consolidated financial statements. The results of operations are impacted significantly by our acquisitions described elsewhere herein.

(in millions, except per share data)	Year Ended December 31,				
	2002	2001	2000	1999	1998
Statement of Operations Data:					
Sales	\$4,011.2	\$2,347.4	\$1,910.1	\$1,405.5	\$1,037.0
Operating income	454.0	275.3 ⁽¹⁾	222.7 ⁽¹⁾	150.5 ⁽¹⁾	100.3 ⁽¹⁾
Interest expense, net of interest and other income	117.5	84.5	88.6	55.1	46.8
Minority interest	6.2	4.5	—	—	—
Provision for income taxes	117.9	70.8	51.4	36.7	20.9
Income before extraordinary loss and cumulative effect of a change in accounting principle	212.4	115.5	82.7	58.7	32.6
Extraordinary loss on extinguishment of debt	(9.9)	—	—	—	—
Cumulative effect of a change in accounting principle	(24.4)	—	—	—	—
Net income	\$ 178.1	\$ 115.5 ⁽²⁾	\$ 82.7 ⁽²⁾	\$ 58.7 ⁽²⁾	\$ 32.6 ⁽²⁾
Earnings per common share:					
Basic:					
Income before extraordinary loss and accounting change	\$ 2.44	\$ 1.54 ⁽³⁾	\$ 1.24 ⁽³⁾	\$ 0.91 ⁽³⁾	\$ 0.66 ⁽³⁾
Extraordinary loss	(0.11)	—	—	—	—
Accounting change	(0.28)	—	—	—	—
Net income	\$ 2.05	\$ 1.54 ⁽³⁾	\$ 1.24 ⁽³⁾	\$ 0.91 ⁽³⁾	\$ 0.66 ⁽³⁾
Diluted:					
Income before extraordinary loss and accounting change	\$ 2.29	\$ 1.47 ⁽³⁾	\$ 1.18 ⁽³⁾	\$ 0.88 ⁽³⁾	\$ 0.63 ⁽³⁾
Extraordinary loss	(0.11)	—	—	—	—
Accounting change	(0.25)	—	—	—	—
Net income	\$ 1.93	\$ 1.47 ⁽³⁾	\$ 1.18 ⁽³⁾	\$ 0.88 ⁽³⁾	\$ 0.63 ⁽³⁾
Weighted average common shares outstanding:					
Basic	86.9	74.9	66.7	64.2	49.4
Diluted	97.4	85.4	69.9	67.0	51.8
Balance Sheet Data (at period end):					
Working capital	\$ 942.7	\$ 717.8	\$ 360.9	\$ 255.5	\$ 157.8
Total assets	5,242.3	3,339.2	2,463.5	1,628.7	1,285.4
Long-term debt	1,847.8	1,315.3	1,095.0	605.0	605.0
Minority interest	73.2	69.9	—	—	—
Shareholders' equity	2,202.2	1,213.9	692.6	583.2	300.0

(1) Effective January 1, 2002, we ceased amortizing goodwill. Goodwill amortization expense recorded in years prior to 2002 was \$42.3 million in 2001, \$35.0 million in 2000, \$20.6 million in 1999 and \$13.8 million in 1998.

(2) Net income, as adjusted to exclude goodwill amortization expense, net of income tax expense, was \$149.4 million in 2001, \$112.3 million in 2000, \$76.2 million in 1999 and \$43.7 million in 1998.

(3) Basic earnings per share, as adjusted, was \$1.99 in 2001, \$1.68 in 2000, \$1.19 in 1999 and \$0.89 in 1998. Diluted earnings per share, as adjusted, was \$1.87 in 2001, \$1.61 in 2000, \$1.14 in 1999 and \$0.84 in 1998.

Management's Discussion and Analysis of Results of Operations and Financial Condition

Overview

We are a leading merchant supplier of secure communications and intelligence, surveillance and reconnaissance (ISR) systems, training, simulation and support services, aviation products and aircraft modernization, as well as specialized products. Our customers include the DoD and prime contractors thereof, certain U.S. Government intelligence agencies, major aerospace and defense contractors, foreign governments, commercial customers and certain other U.S. federal, state and local government agencies. We have the following four reportable segments: (1) Secure Communications & ISR; (2) Training, Simulation & Support Services; (3) Aviation Products & Aircraft Modernization; and (4) Specialized Products.

Our Secure Communications & ISR segment provides products and services for the global ISR market as well as secure, high data rate communications systems and equipment primarily for military and other U.S. Government reconnaissance and surveillance applications. We believe our systems and products are critical elements of virtually all major communication, command and control, intelligence gathering and space systems. Our systems and products are used to connect a variety of airborne, space, ground and sea-based communication systems and are used in the transmission, processing, recording, monitoring and dissemination functions of these communication systems. Our Training, Simulation & Support Services segment produces training systems and related support services, and provides a wide range of engineering development and integration support, a full range of teaching, training, logistics and communication software support services, crisis management software and custom ballistic targets. Our Aviation Products & Aircraft Modernization segment provides our TCAS products, cockpit voice, flight data and cruise ship hardened voyage recorders, ruggedized custom displays and specialized aircraft modernization, upgrade and maintenance services. Our Specialized Products segment provides ocean products, telemetry, instrumentation, space and guidance products, premium fuzing products, security systems, training devices and motion simulators, video security and surveillance and electro-optic surveillance systems, ruggedized commercial-off-the-shelf technology and microwave components.

In recent years, domestic and worldwide political and economic developments have significantly affected the markets for defense systems, products and services. Two events in 2001 had a dramatic impact on the domestic and international political and economic landscape. They impacted L-3 and the defense industry generally. First, the events of September 11 created uncertainty and exposed vulnerabilities in the security and the overall defense of the U.S. homeland. Second, in the conclusions of the U.S. Quadrennial Defense Review (QDR) completed during 2001 there was a fundamental and philosophical shift in focus from a "threat-based" model to one that emphasizes the capabilities needed to defeat a full spectrum of adversaries. Transforming the nation's defense posture to a capabilities-based approach involves creating the ability for a more flexible response, with greater force mobility, stronger space capabilities, missile defense, improved and network-centric communications and information systems security and an increased emphasis on homeland defense.

The actual fiscal 2003 DoD budget authority was \$365 billion and the DoD budget request for fiscal years 2004 through 2009 indicate a compounded annual growth rate of 5.8% with \$484 billion for fiscal 2009. More important are the trends for the "investment account" which is comprised of the procurement and research, development, test and evaluation (RDT&E) components of the DoD budget. We believe the investment account is a better indicator of the portion of the DoD budget that is applicable to defense contractors. The investment account increased 15% in fiscal year 2003 to \$127 billion and the DoD budget investment account requests for fiscal years 2004 to 2009 indicate a compounded annual growth rate of 7.5% with \$182 billion in fiscal year 2009. Additionally, the DoD budgets have experienced increased focus on command, control, communications, intelligence, surveillance and reconnaissance (C³ISR), precision-guided weapons, unmanned aerial vehicles (UAVs), network-centric communications, Special Operations Forces (SOF) and missile defense. We believe L-3 is well positioned to benefit from increased spending in those areas. In addition, increased emphasis on homeland defense may increase demand for our capabilities in areas such as security systems, information security, crisis management, preparedness and

prevention services, and civilian security operations. While there is no assurance that the requested DoD budget increases will be approved by Congress, after over a decade of downward trends, the current outlook is one of continued increased DoD spending, which we believe would positively affect our future orders and sales and favorably affect our future operating profits because of increased sale volumes.

All of our domestic government contracts and sub-contracts are subject to audit and various cost controls, and include standard provisions for termination for the convenience of the U.S. Government. Multiyear U.S. Government contracts and related orders are subject to cancellation if funds for contract performance for any subsequent year become unavailable. Foreign government contracts generally include comparable provisions relating to termination for the convenience of the relevant foreign government.

Acquisitions and Divestitures

The table below summarizes the more significant acquisitions that we have completed during the three years ended December 31, 2002.

Acquired Business	Date Acquired	Purchase Price ⁽¹⁾ (in millions)
Training Devices and Training Services (TDTS) business of Raytheon Company	February 10, 2000	\$ 158.1 ⁽²⁾
LNR and EMP businesses of Trex Communications Corporation	February 14, 2000	\$ 49.3
Traffic Alert and Collision Avoidance Systems business of Honeywell International Inc.	April 28, 2000	\$ 239.2
MPRI, Inc.	June 30, 2000	\$ 39.6
Coleman Research Corporation	December 29, 2000	\$ 62.3 ⁽³⁾
KDI Precision Products	May 4, 2001	\$ 78.9
EER Systems	May 31, 2001	\$ 124.4
Spar Aerospace Limited	November 23, 2001	\$ 146.8
Emergent Government Services Group	November 30, 2001	\$ 39.8 ⁽⁴⁾
BT Fuze Products	December 19, 2001	\$ 51.1 ⁽⁵⁾
SY Technology (SY)	December 31, 2001	\$ 58.5 ⁽⁶⁾
Aircraft Integration Systems (AIS) business of Raytheon Company	March 8, 2002	\$1,148.7 ⁽⁷⁾
Detection Systems	June 14, 2002	\$ 110.0 ⁽⁸⁾
Telos Corporation (a California Corporation)	July 19, 2002	\$ 22.3
ComCept, Inc.	July 31, 2002	\$ 25.5 ⁽⁹⁾⁽¹⁰⁾
Technology, Management and Analysis Corporation (TMA)	September 23, 2002	\$ 51.4 ⁽⁹⁾⁽¹¹⁾
Electron Devices and Displays-Navigation Systems — San Diego businesses of Northrop Grumman	October 25, 2002	\$ 135.0 ⁽⁹⁾⁽¹²⁾
Wolf Coach, Inc.	October 31, 2002	\$ 4.2 ⁽⁹⁾⁽¹³⁾
International Microwave Corporation (IMC)	November 8, 2002	\$ 40.7 ⁽⁹⁾⁽¹⁴⁾
Westwood Corporation	November 13, 2002	\$ 22.1
Wescam Inc.	November 21, 2002	\$ 124.3
Ship Analytics, Inc.	December 19, 2002	\$ 12.5 ⁽⁹⁾⁽¹⁵⁾

(1) The purchase price represents the contractual consideration for the acquired business excluding adjustments for net cash acquired and acquisition costs.

(2) Following the acquisition we changed TDTS's name to L-3 Communications Link Simulation and Training.

(3) Includes \$2.3 million of additional preliminary purchase price yet to be paid that was based on the financial performance of Coleman for the year ended December 31, 2001.

(4) Following the acquisition, we changed Emergent Government Services Group's name to L-3 Communications Analytics.

(5) Excludes additional purchase price, not to exceed \$2.5 million, which is contingent upon the financial performance of BT Fuze Products for the year ending December 31, 2003.

(6) Excludes additional purchase price, not to exceed \$3.0 million, which is contingent upon the financial performance of SY for the year ended December 31, 2002 and the year ending December 31, 2003.

(7) Includes \$18.7 million related to additional assets contributed by Raytheon Company (Raytheon) to AIS. Following the acquisition, we changed AIS's name to L-3 Communications Integrated Systems (IS). The purchase price is subject to adjustment based on actual closing date tangible net assets.

(8) Includes a \$10.0 million preliminary purchase price adjustment. The purchase price is subject to further adjustment based on actual closing date net working capital.

(9) The purchase price is subject to adjustment based on actual closing date net assets or net working capital of the acquired business.

(10) The purchase price consists of \$14.9 million of cash and 229,494 shares of L-3 Holdings common stock valued at \$10.6 million. Excludes additional purchase price in the form of L-3 Holdings common stock, which is contingent upon the financial performance of ComCept for the fiscal years ending June 30, 2003 and 2004. The maximum additional L-3 Holdings common stock payable is 219,088 shares.

(11) Excludes additional purchase price, not to exceed \$7.0 million, which is contingent upon the financial performance of TMA for the twelve months ended September 30, 2003. Following the acquisition, we changed its name to L-3 Communications TMA Corporation.

(12) Following the acquisition, we changed the name of the Displays-Navigation Systems — San Diego business to L-3 Ruggedized Command & Control.

(13) Excludes additional purchase price, not to exceed \$4.1 million, which is contingent upon the financial performance of Wolf Coach for the years ending December 31, 2003, 2004 and 2005.

(14) Excludes additional purchase price, not to exceed \$5.0 million, which is contingent upon the financial performance of IMC for the year ending December 31, 2003.

(15) Excludes additional purchase price, not to exceed \$13.5 million, which is contingent upon the financial performance of Ship Analytics for the years ending December 31, 2003, 2004 and 2005.

Additionally, we purchased other businesses during 2000, 2001 and 2002, which individually and in the aggregate were not material to our consolidated results of operations, financial position or cash flows in the year acquired.

On January 29, 2003 we agreed to acquire Goodrich Avionics Systems, a division of Goodrich Corporation, for \$188.0 million in cash. The acquisition is subject to customary closing conditions, including clearance under the Hart-Scott-Rodino Antitrust Improvement Act. We expect to complete the acquisition in March 2003.

All of our acquisitions have been accounted for as purchase business combinations and are included in our consolidated results of operations from their respective effective dates.

On May 31, 2001, we sold a 30% interest in Aviation Communications and Surveillance Systems LLC (ACSS), which comprises our TCAS business, to Thales Avionics, a wholly owned subsidiary of Thales (formerly Thomson-CSF), for \$75.2 million of cash. We continue to consolidate the financial statements of ACSS.

We regularly evaluate potential acquisitions and joint venture transactions, but we have not entered into any other agreements with respect to any material transactions at this time.

IS Acquisition. In March 2002, L-3 completed its largest and most significant acquisition since L-3's formation in April 1997, with the acquisition of the Aircraft Integration Systems (AIS) business from Raytheon for approximately \$1.2 billion in cash. Following the closing of the acquisition we changed the name of AIS to L-3 Communications Integrated Systems (IS). The IS acquisition expanded L-3's operations in a critical DoD priority area that we believe is central to the DoD's transformation to network-centric warfare, which is a layered communications architecture that enables military platforms from space, air, sea and ground to share information on a real-time basis. Both IS and ComCept, which we acquired in July 2002, are leaders in assisting the DoD in charting the future warfighting activities to achieve the persistent Intelligence, Surveillance and Reconnaissance (ISR) needed to become a more mobile, responsive and lethal force. We believe that L-3 is now at the forefront of assisting in the development of seamless integrated command, control, communications and ISR (C³ISR).

During the fourth quarter of 2002, L-3 completed its final purchase price allocation of the acquisition date balance sheet for the IS acquired assets and assumed liabilities. This

allocation reflects the final appraisals and other valuations of the fair value for the IS acquired assets and assumed liabilities, as well as the results from the audit of AIS's acquired net assets that was performed by our independent auditors (See Note 3 to consolidated financial statements). The adjustments included in the final purchase price allocation increased the intangible assets (primarily goodwill) that we initially recorded for the IS acquisition by \$140.6 million. This increase to the IS intangible assets does not include any adjustment for the final purchase price of AIS, which will be based on the difference between AIS's final closing date net tangible book value, as defined in the AIS asset purchase agreement, and the AIS net tangible book value as of September 30, 2001, which we expect to result in a reduction to the AIS purchase price. We have submitted our proposed purchase price adjustment in accordance with the asset purchase agreement to Raytheon, the seller of the AIS business, which amounts to a reduction of \$100 million to the final purchase price submitted by Raytheon to L-3. We expect to resolve the final purchase price for AIS with Raytheon in 2003. Any amount received by L-3 for a reduction to the AIS purchase price will be recorded as a reduction to the IS goodwill.

The most significant adjustments to the initial purchase price allocation pertain to revisions of \$86.1 million to update estimated costs to complete the AIS acquired contracts as of the date of acquisition to reflect circumstances that existed prior to the date of acquisition, and \$74.5 million of adjustments resulting from the valuation of acquired contracts in process at their estimated contract values, less L-3's estimated costs to complete the contracts and a reasonable profit allowance on L-3's completion effort. The AIS acquired contracts in process had aggregate contract values of approximately \$3.9 billion, including funded and unfunded amounts, with approximately \$1.0 billion of funded backlog at the date of acquisition.

The majority of the revisions to estimated costs to complete acquired contracts relate to the Sea Sentinel contract, with other amounts relating to the Extract, Peace Pioneer, SIVAM, SRP and LC-130 contracts. The AIS acquired contracts in process reflected in L-3's initial purchase price allocation were based on September 2001 contract estimates prepared by AIS. L-3 updated AIS's September 2001 contract estimates for the five months of activity and changes in circumstances, which occurred before the effective date of the acquisition, March 1, 2002, in order to complete the audit of the AIS acquired net assets and prepare the final purchase

price allocation. L-3 was not able to finalize and complete its assessments of the estimated costs to complete the AIS contracts until after we acquired AIS and obtained full access to the data underlying the contracts enabling us to perform complete “bottoms-up” estimates for all of the AIS contracts. Most of the revisions are related to foreign contracts for which we do not expect any significant contract renewals after we complete them. The largest adjustment is related to Sea Sentinel which is a \$450 million, firm fixed-price contract with the Royal Australian Air Force (RAAF), that was awarded to AIS in August 1994. The contract provides the RAAF with upgraded mission equipment on 18 P-3C RAAF aircraft and the delivery and installation of an operational mission simulator, a systems engineering laboratory and a mission replay and analysis module. AIS experienced design, schedule and cost growth problems on the Sea Sentinel contract for several years. As of March 1, 2002, AIS had delivered three of the total 18 aircraft required to be delivered under the contract, none of the aircraft had been accepted by the customer and \$435 million of the Sea Sentinel contract value of \$450 million had been recognized as revenue. L-3 believes that it has resolved all of the major performance issues on Sea Sentinel, and since the acquisition we have delivered four additional aircraft to the customer and seven aircraft have been accepted by the customer. We expect to deliver the final aircraft to the customer in February 2005.

We expect to increase the sales and improve the operating margins and cash flows of the IS acquired business by implementing cost reduction actions and business processes and controls, which L-3 undertakes for all of its acquisitions. The cost reduction actions include reducing overhead and administration costs of our acquired businesses, which we accomplish by maintaining disciplined cost controls. We also have placed new financial management at IS and have performed a comprehensive review of all direct and indirect costs for each department of the business to eliminate non-value added costs and expenses and staff functions. We also have implemented L-3’s disciplined contract bid and proposal controls to improve competitive contract award win rates and increase profitability on IS’s future contract renewals and new business. As a result of these undertakings, we expect to increase the average profit rate that IS earns on the new contracts and contract renewals awarded after the acquisition date, and by the end of the first half of

2003 we expect to reduce the annual operating costs and expenses of the IS business by more than \$50 million.

Critical Accounting Policies

Our significant accounting policies are described in Note 2 to the consolidated financial statements. The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of sales and costs and expenses during the reporting period. The most significant of these estimates and assumptions relate to contract estimates of sales and estimated costs to complete contracts in process, estimates of market values for inventories reported at lower of cost or market, estimates of pension and post-retirement benefit obligations, recoverability of recorded amounts of fixed assets, identifiable intangible assets and goodwill, income taxes, including the valuations of deferred tax assets, litigation and environmental obligations. Actual amounts will differ from these estimates. We believe that critical accounting estimates have the following attributes: (1) we are required to make assumptions about matters that are highly uncertain at the time of the estimate; and (2) different estimates we could reasonably have used, or changes in the estimate that are reasonably likely to occur, would have a material effect on our financial condition or results of operations. We believe the following critical accounting policies contain the more significant judgements and estimates used in the preparation of our financial statements.

Contract Revenue Recognition and Contract Estimates. The substantial majority of our sales to the U.S. Government and certain of our sales to foreign governments and commercial customers are made pursuant to written contractual arrangements or “contracts” to design, develop, manufacture and/or modify complex products, to the buyers’ (customers’) specifications and to provide services related to the performance of such contracts. These contracts are within the scope of the American Institute of Certified Public Accountants Statement of Position 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts* (SOP 81-1), and cost-reimbursable contracts with the U.S. Government are also specifically within the scope of

Accounting Research Bulletin No. 43, Chapter 11, Section A, *Government Contracts, Cost-Plus-Fixed Fee Contracts* (ARB 43). Certain of our contracts with the U.S. Government are multi-year contracts that are funded annually by the customer, and sales on these multi-year contracts are based on amounts appropriated (funded) by the U.S. Government.

Sales and profits on fixed-price contracts are recognized using percentage-of-completion methods of accounting. Sales and profits on fixed-price production contracts whose units are produced and delivered in a continuous or sequential process are recorded as units are delivered based on their selling prices (the “units-of-delivery” method). Sales and profits on other fixed-price contracts are recorded based on the ratio of total actual incurred costs to date to the total estimated costs at completion of the contract for each contract (the “cost-to-cost method”). Under the percentage-of-completion methods of accounting, a single estimated total profit margin is used to recognize profit for each contract over its entire period of performance which can exceed one year.

Accounting for the sales and profit on a fixed-price contract requires estimates of (1) the contract value or total contract revenue, (2) the total costs at completion, which is equal to the sum of the actual incurred costs to date on the contract and the estimated costs to complete the contract’s scope of work and (3) the measurement of progress towards completion. The estimated profit or loss on a contract is equal to the difference between the total contract value and the estimated total cost at completion. Under the units-of-delivery percentage-of-completion method, sales on a fixed-price contract are recorded as the units are delivered during the period at an amount equal to the contractual selling price of those units. Under the cost-to-cost percentage-of-completion method, sales on a fixed-price contract are recorded at amounts equal to the ratio of cumulative costs incurred to date to total estimated costs at completion multiplied by the contract value, less the cumulative sales recognized in prior periods. The profit recorded on a contract in any period under both the units-of-delivery method and cost-to-cost method is equal to the current estimated total profit margin for the contract stated as a percentage of contract revenue multiplied by the cumulative sales recorded less the cumulative profit previously recorded. Adjustments to original estimates for a contract’s revenues, estimated costs at completion and estimated total profit are often required as work progresses under a

contract, as experience is gained and as more information is obtained, even though the scope of work required under the contract may not change, or if contract modifications occur. These changes are recorded on a cumulative catch-up basis in the period they are determined to be necessary.

Sales and profits on a cost-reimbursable contract are recognized as allowable costs are incurred on the contract and become billable to the customer, in an amount equal to the allowable costs plus the profit on those cost which is generally fixed or variable based on the contract fee arrangement. Thus, cost-reimbursable contracts are generally not subject to the same estimation risks that affect fixed price contracts.

The impact of revisions in profit estimates on both fixed-price and cost-reimbursable contracts are recognized on a cumulative catch-up basis in the period in which the revisions are made. Provisions for anticipated losses on contracts are recorded in the period in which they become evident. Amounts representing contract change orders or claims are included in sales only when they can be reliably estimated and their realization is reasonably assured. The revisions in contract estimates, if significant, can materially affect our results of operations and cash flows, as well as our valuations of contracts in process.

For the year ended December 31, 2002: (1) sales on fixed-price contracts recognized using the units-of-delivery percentage-of-completion method accounted for approximately 22.4% of total sales, (2) sales on fixed-price contracts recognized using the cost-to-cost percentage of completion method accounted for approximately 32.7% of total sales, and (3) sales on cost-reimbursable contracts, which are recognized as costs are incurred, accounted for approximately 34.2% of total sales. The remaining 10.7% of sales for the year ended December 31, 2002 pertain to fixed-price sales arrangements principally with commercial customers, which were not within the scope of SOP 81-1 or ARB 43 and were recorded as products are delivered and services are performed.

Goodwill and Intangible Assets. L-3 reviews goodwill and intangible assets for impairment whenever events or changes in circumstances indicate that the carrying amount of these assets may not be recoverable, and also reviews goodwill annually in accordance with SFAS No. 142, *Goodwill and Other Intangible Assets*. In accordance with SFAS No. 141, *Business Combinations*, L-3 recorded identifiable

intangible assets, such as customer relationships, that are acquired in connection with a business acquisition. The value assigned to identifiable intangible assets are determined based on estimates and judgements regarding expectations for future contract renewals and their related cash flows and the life cycle of acquired products and their related cash flows. If actual future contract renewals differ significantly from the estimates, we may be required to record an impairment charge to write down the identifiable intangible asset to its realizable value. In addition, SFAS No. 142 requires that goodwill be tested annually using a two-step process. The first step is to identify any potential impairment by comparing the carrying value of the reporting unit to its fair value. If a potential impairment is identified, the second step is to compare the implied fair value of goodwill with its carrying amount to measure the impairment loss. The fair value of a reporting unit is estimated using a discounted cash flow valuation approach, and is dependent on estimates for future sales, operating income, depreciation and amortization, income tax payments, working capital changes, and capital expenditures, as well as expected growth rates for cash flows and long-term interest rates, all of which are impacted by economic conditions related to the industries in which we operate as well as conditions in the U.S. capital markets. A decline in estimated fair value of a reporting unit could result in an unexpected impairment charge to goodwill, which could have a material adverse effect on our business, financial condition and results of operations.

Pension Plan and Postretirement Benefit Plan

Obligations. The obligations for our pension plans and postretirement benefit plans and the related annual costs of employee benefits are calculated based on several long-term assumptions, including discount rates, rates of return on plan assets, expected annual rates for salary increases for employee participants in the case of pension plans, and expected annual increases in the costs of medical and other health care benefits in the case of postretirement benefit obligations. These long-term assumptions are subject to revision based on changes in interest rates, financial market conditions, expected versus actual returns on plan assets, participant mortality rates and other actuarial assumptions, future rates of salary increases, benefit formulas and levels, and rates of increase in the costs of benefits. Such changes, if significant, can materially affect the amount of annual net

periodic benefit costs recognized in results of operations, our liabilities for the pension plans and postretirement benefit plans, and our annual cash requirements to fund these plans.

Valuation of Deferred Income Tax Assets and Liabilities. At December 31, 2002, we had net deferred tax assets of \$290.8 million, including \$6.6 million for net operating loss carryforwards and \$38.4 million for tax credit carryforwards which are subject to various limitations and will expire if unused within their respective carryforward periods. Deferred income taxes are determined separately for each of our tax-paying entities in each tax jurisdiction. The future realization of our deferred income tax assets ultimately depends on our ability to generate sufficient taxable income of the appropriate character (for example, ordinary income or capital gain) within the carryback and carryforward periods available under the tax law, and to a lesser extent, our ability to execute successful tax planning strategies. Based on our estimates of the amounts and timing of future taxable income and tax planning strategies, we believe that we will realize our recorded deferred tax assets. A change in the ability of our operations to continue to generate future taxable income, or our ability to implement desired tax planning strategies, could affect our ability to realize the future tax deductions underlying our net deferred tax assets, and require us to provide a valuation allowance against our net deferred tax assets. Such changes, if significant, could have a material impact in our effective tax rate, results of operations and financial position in any given period.

Results of Operations

The following information should be read in conjunction with our consolidated financial statements. Our results of operations for the periods presented are impacted significantly by our acquisitions (see Note 3 to the consolidated financial statements for a discussion of our acquisitions, including pro forma sales, net income and diluted earnings per share data for the years ended December 31, 2002 and 2001). We present our sales and cost and expenses in two categories on the statement of operations, "Contracts, primarily U.S. Government" and "Commercial, primarily products," which are based on how we recognize revenue. Sales and costs and expenses for L-3's businesses that are primarily U.S. Government contractors are presented as "Contracts, primarily U.S. Government." The sales for L-3's U.S. Government

contractor businesses are transacted using written contractual arrangements or “contracts” for products and services according to the specifications of the customer and are within the scope of SOP 81-1 and ARB 43. Sales reported under “Contracts, primarily U.S. Government” also include certain sales by L-3’s U.S. Government contractor businesses transacted using contracts for domestic and foreign commercial customers which also are within the scope of SOP 81-1. Sales and costs and expenses for L-3’s businesses whose customers are primarily commercial customers are presented as “Commercial, primarily products.” These sales to commercial

customers are not within the scope of SOP 81-1 or ARB 43, and are recognized in accordance with SEC SAB No. 101. L-3’s commercial businesses are substantially comprised of Aviation Communication & Surveillance Systems (ACSS), Aviation Recorders, Microwave components, the Detection Systems business acquired from PerkinElmer, Inc., Satellite Networks, and PrimeWave Communications. The tables below provide selected statement of operations data for L-3’s U.S. Government contractor businesses and L-3’s commercial businesses, and for each of L-3’s reportable segments for the years ended December 31, 2002, 2001 and 2000.

Statement of Operations Data

(in millions)	Year ended December 31,		
	2002	2001	2000
Sales:			
Contracts, primarily U.S. Government	\$3,581.1	\$1,932.2	\$1,584.8
Commercial, primarily products	430.1	415.2	325.3
Total	\$4,011.2	\$2,347.4	\$1,910.1
Operating Income:			
Contracts, primarily U.S. Government	\$ 443.6	\$ 232.6 ⁽¹⁾	\$ 196.6 ⁽¹⁾
Commercial, primarily products	10.4	42.7 ⁽¹⁾	26.1 ⁽¹⁾
Total	\$ 454.0	\$ 275.3	\$ 222.7
Sales by Reportable Segment⁽²⁾:			
Secure Communications & ISR	\$ 997.8	\$ 450.5	\$ 393.0
Training, Simulation & Support Services	806.3	596.8	283.4
Aviation Products & Aircraft Modernization	733.0	263.3	209.1
Specialized Products	1,474.1	1,036.8	1,024.6
Total	\$4,011.2	\$2,347.4	\$1,910.1
Operating Income by Reportable Segment:			
Secure Communications & ISR	\$ 104.1	\$ 32.0 ⁽¹⁾	\$ 54.1 ⁽¹⁾
Training, Simulation & Support Services	96.5	65.7 ⁽¹⁾	23.5 ⁽¹⁾
Aviation Products & Aircraft Modernization	105.1	85.6 ⁽¹⁾	66.9 ⁽¹⁾
Specialized Products	148.3	92.0 ⁽¹⁾	78.2 ⁽¹⁾
Total	\$ 454.0	\$ 275.3	\$ 222.7

(1) Operating income includes goodwill amortization expense for the years ended December 31, 2001 and 2000 as follows:

	2001	2000
Contracts, primarily U.S. Government	\$31.3	\$25.0
Commercial, primarily products	11.0	10.0
Total	\$42.3	\$35.0
Secure Communications & ISR	\$ 3.8	\$ 3.7
Training, Simulation & Support Services	7.1	3.6
Aviation Products & Aircraft Modernization	7.7	6.5
Specialized Products	23.7	21.2
Total	\$42.3	\$35.0

(2) Sales are after intersegment eliminations. See Note 18 to the consolidated financial statements.

Year Ended December 31, 2002 Compared with Year Ended December 31, 2001

Consolidated sales increased \$1,663.8 million to \$4,011.2 million for 2002 from \$2,347.4 million for 2001. For 2002, sales grew \$347.4 million, or 14.8%, excluding the increase in sales from acquired businesses of \$1,316.4 million discussed below. Had these acquisitions occurred on January 1, 2001, pro forma sales for 2002 would have been \$4,699.1 million, an increase of 13.5% over pro forma sales of \$4,139.6 million for 2001 (see Note 3 to the consolidated financial statements).

Sales from "Contracts, primarily U.S. Government" increased \$1,648.9 million to \$3,581.1 million for 2002 from \$1,932.2 million for 2001. The Analytics, BT Fuze, ComCept, EER, Electron Devices, IS, KDI, Ruggedized Command & Control, Ship Analytics, Spar, SY, Telos, TMA, Wescam and Westwood acquired businesses contributed \$1,222.5 million of the increase in sales. Excluding these acquisitions, sales grew \$426.4 million, or 22.1%, in 2002. Volume increased \$320.9 million for explosive detection systems, \$156.8 million for secure communication systems, \$20.6 million for training services and devices, \$20.1 million for navigation and guidance products and \$8.1 million for military displays products. These sales increases were partially offset by declines of \$17.3 million on naval power equipment and \$14.5 million on static transfer switches used for commercial applications. Sales of ballistic missile targets and services declined \$53.0 million. The remaining decline in sales of \$15.3 million was primarily related to acoustic undersea warfare products because of lower volume on spares.

Sales from "Commercial, primarily products" increased \$14.9 million to \$430.1 million for 2002 from \$415.2 million for 2001. The Detection Systems, IMC and Wolf Coach acquired businesses contributed \$93.9 million of the increase in sales. Excluding these acquisitions, sales declined \$79.0 million or 19.0%. This decrease in sales was due to volume declines of \$49.2 million on commercial aviation products, \$31.7 million on microwave components and \$11.8 million on PrimeWave communication products. These declines were partially offset by increases of \$5.5 million for maritime voyage recorders and \$8.2 million primarily for technical and product support services for commercial customers.

"Commercial, primarily products" sales declined to 10.7% of total sales for 2002 from 17.7% for 2001. The decline was primarily attributable to the acquisitions we completed

during 2002, including the IS acquisition, and to a lesser extent, the decline in our commercial sales. This decline was attributable to the continued weakness in the commercial aviation and communications markets. Our 2002 acquisitions were comprised substantially of DoD contractors. Even if a rebound occurs in the commercial aviation and communications markets, which we are not anticipating for 2003, we expect our commercial sales as a percentage of total sales to remain at the current level. Furthermore, even considering our stated interest in expanding L-3's business in avionics for both military and commercial applications through select niche acquisitions, we do not expect to make any substantial acquisitions of commercial businesses.

Consolidated costs and expenses increased \$1,485.1 million to \$3,557.2 million for 2002 from \$2,072.1 million for 2001, primarily as a result of the increase in sales. In accordance with SFAS No. 142, on January 1, 2002 we stopped amortizing our goodwill to expenses. Goodwill amortization expense was \$42.3 million for 2001. SFAS No. 142 also requires that we evaluate the fair value of our goodwill annually to determine if it has been impaired. We evaluated the carrying value of our goodwill as of January 1, 2002 in accordance with the transition provisions of SFAS No. 142 and wrote-off \$30.8 million of goodwill related to certain of our space and broadband commercial communications businesses, which has been reported as a \$24.4 million loss after income taxes for the cumulative effect of a change in accounting principle, as discussed below. If we experience any impairments to the carrying value of our goodwill after January 1, 2002, we will have to report them as a loss from operations. During 2002, we did not have any other goodwill impairments. We expect to perform our annual impairment test during the first quarter of 2003.

Costs and expenses for "Contracts, primarily U.S. Government" increased \$1,437.9 million to \$3,137.5 million for 2002 from \$1,699.6 million for 2001. Approximately 75% of the increase is attributable to our acquired businesses. The remaining increase is primarily attributed to internal growth for explosive detection systems and secure communication systems. Goodwill amortization expense was \$31.3 million for 2001. Costs and expenses for sales on our direct and indirect contracts with the U.S. Government include selling, general and administrative (SG&A) costs, including independent research and development and bid and proposal costs,

because SG&A costs are allowable indirect contract costs that we allocate to our U.S. Government contracts in accordance with U.S. Government regulations. Accordingly, we do not report SG&A costs on U.S. Government contracts as period expenses. SG&A costs allocated to our U.S. Government contracts were \$431.5 million for 2002 and \$304.3 million for 2001 (see Note 4 to our consolidated financial statements).

Costs and expenses for “Commercial, primarily products” increased \$47.2 million to \$419.7 million for 2002 from \$372.5 million for 2001. The increase is primarily due to increased sales as a result of the Detection Systems acquired business, which was partially offset by lower expenses for microwave components products due to lower sales volume. Goodwill amortization expense was \$11.0 million for 2001. SG&A expenses, including research and development (R&D) expenses, increased \$29.2 million to \$148.9 million for 2002 from \$119.7 million for 2001, primarily because of SG&A expenses incurred by our acquired businesses.

Consolidated operating income increased by \$178.7 million to \$454.0 million for 2002 from \$275.3 million for 2001. The increase was due to higher sales for all of our segments. The impact of not amortizing goodwill increased consolidated operating income by \$42.3 million. Consolidated operating income as a percentage of sales (operating margin) declined by 0.4 percentage points to 11.3% for 2002 from 11.7% for 2001. The impact of not amortizing goodwill increased consolidated operating margin by 1.1 percentage points. Operating margins compared to operating margins for 2001, excluding goodwill amortization expense, declined for our Training, Simulation & Support Services, Aviation Products & Aircraft Modernization and Specialized Products segments, and increased for our Secure Communications & ISR segment. The changes in the operating margins for our segments are discussed below.

Operating income for “Contracts, primarily U.S. Government” increased \$211.0 million to \$443.6 million for 2002 from \$232.6 million for 2001. Operating margin increased 0.4 percentage points to 12.4% for 2002, from 12.0% for 2001. The impact of not amortizing goodwill increased operating margin by 0.9 percentage points. Operating income for 2002 includes a loss of \$3.0 million for the settlement in June 2002 of certain litigations that we assumed in connection with a business we acquired in 1999, which reduced operating margin for 2002 by 0.1 percentage

points. The remaining decline in operating margin was due to the absence in 2002 of a favorable performance adjustment recorded in 2001 on the AVCATT contract. Operating income included approximately \$20 million of losses in both 2002 and 2001 related to our naval power equipment business that were caused by production problems which reduced sales volume and related costs to fix manufacturing and quality control problems. We expect to reduce the losses in our naval power equipment business to about \$5 million for 2003 because of higher sales related to increasing production levels.

Operating income for “Commercial, primarily products” declined \$32.3 million to \$10.4 million for 2002 from \$42.7 million for 2001. Operating margin declined 7.9 percentage points to 2.4% for 2002 from 10.3% for 2001. The decline was principally attributable to lower gross margin contributions from commercial aviation products, microwave components, and space and broadband communication products because of volume declines, as well as continued marketing, selling and development expenses for the PrimeWave business. The impact of not amortizing goodwill partially offset these decreases in operating margin by 2.6 percentage points. We expect to reduce our losses from the PrimeWave Communications business by approximately \$20 million in 2003 because of higher expected sales volume and lower R&D and SG&A expenses for the business.

Interest expense increased \$36.1 million to \$122.5 million for 2002 from \$86.4 million for 2001. The increase is attributable to higher outstanding debt for 2002 primarily related to the financing of the IS acquisition, which was partially offset by lower interest rates on our debt. Our interest rate swap agreements which converted the fixed interest rates on \$580.0 million of our senior subordinated notes to variable interest rates reduced our interest expense for 2002 by \$9.6 million because of declining interest rates that the interest rate swaps enabled us to enjoy. In June 2002, we also redeemed our \$225.0 million 10 3/8% senior subordinated notes and replaced them with senior subordinated notes that have a 7 5/8% fixed interest rate which reduced our interest expense by \$3.1 million. See “Liquidity and Capital Resources — Financing Activities” below.

Interest and other income increased \$3.2 million to \$4.9 million for 2002 from \$1.7 million for 2001, principally due to interest income earned on our cash and cash

equivalents. Additionally, 2001 included a net gain of \$0.6 million comprising a gain on the sale of a 30% interest in the ACSS business, largely offset by the write-down of the carrying value of an investment in the common stock of a telecommunications company, because the decline in value for that common stock was determined to be other than temporary.

The income tax provision for 2002 is based on an effective income tax rate of 35.7%, compared with an effective income tax rate of 38.0% for the year ended December 31, 2001. The decrease in the effective income tax rate is primarily attributable to the adoption of SFAS No. 142.

Amortization expense for goodwill that is not deductible for income tax purposes caused an increase in our effective income tax rate prior to the adoption of SFAS No. 142.

Basic earnings per share (EPS) before extraordinary item and cumulative effect of a change in accounting principle increased \$0.90 to \$2.44 for 2002 from \$1.54 for 2001. Diluted EPS before extraordinary item and cumulative effect of a change in accounting principle increased \$0.82 to \$2.29 for 2002 from \$1.47 for 2001. The impact of not amortizing goodwill in 2002 increased basic EPS before extraordinary item and cumulative effect of a change in accounting principle by \$0.45 and diluted EPS before extraordinary item and cumulative effect of a change in accounting principle by \$0.40. Excluding the increase in earnings attributable to not amortizing goodwill, basic EPS before extraordinary item and cumulative effect of a change in accounting principle grew 22.6% and diluted EPS before extraordinary item and cumulative effect of a change in accounting principle grew 22.5%. Basic EPS was \$2.05 and diluted EPS was \$1.93 after an extraordinary loss of \$9.9 million (\$0.11 per basic and diluted share) on the early extinguishment of debt arising from the retirement of our \$225.0 million of 10 3/8% senior subordinated notes and a loss of \$24.4 million (\$0.28 per basic share and \$0.25 per diluted share) for the cumulative effect of a change in accounting principle for a goodwill impairment, recorded effective as of January 1, 2002 in connection with the adoption of SFAS No. 142.

Diluted weighted-average common shares outstanding increased 14.1% to 97.4 million for 2002 from 85.4 million for 2001. The increase principally reflects the additional shares outstanding from the sale of 9.2 million shares of our common stock effective May 2, 2001, and the sale of 14.0 million shares of our common stock effective June 28, 2002.

The diluted EPS computation for 2002 did not include the dilutive effect of the 7.8 million shares of L-3 Holdings common stock that are issuable upon conversion of the CODES (See Notes 8 and 12 to the consolidated financial statements) because the conditions for their conversion were not satisfied. However, if the CODES had been convertible, reported diluted EPS would have decreased by approximately \$0.03 for 2002.

Secure Communications & ISR

Sales for the Secure Communications & ISR segment increased \$547.3 million to \$997.8 million for 2002 from \$450.5 million for 2001. The IS-Tactical Reconnaissance Systems including airborne surveillance & control (TRS) and ComCept acquired businesses contributed \$403.1 million of sales. Excluding these acquisitions, sales grew \$144.2 million or 32.0%. Volumes on secure communication systems, including Secure Terminal Equipment (STE), secure data links and military communications products increased \$156.8 million because of greater demand for secure communications from the DoD and U.S. Government intelligence agencies. These increases were partially offset by a decrease in sales of \$12.6 million primarily due to lower volumes of PrimeWave communication products. We expect that the demand for our secure communications systems and ISR products will remain strong for 2003, enabling the segment to generate sales growth in 2003, excluding acquisitions, in excess of 10%.

Operating income increased by \$72.1 million to \$104.1 million for 2002 from \$32.0 million for 2001 because of higher sales and operating margin. Operating margin improved by 3.3 percentage points to 10.4% for 2002 compared to 7.1% for 2001. The impact of not amortizing goodwill increased operating margin by 0.4 percentage points. Increased volume and cost improvements on secure communication systems increased margins by 1.7 percentage points. Higher losses for the PrimeWave business in 2002 due to lower sales, higher marketing, selling and development expenses and a provision to increase the allowance for doubtful accounts by \$3.0 million lowered operating margin by 0.9 percentage points. The remaining change in operating margins was principally attributable to margins from the IS-TRS acquired business, which was higher than the segment operating margin for 2001.

Training, Simulation & Support Services

Sales for the Training, Simulation & Support Services segment increased \$209.5 million to \$806.3 million for 2002 from \$596.8 million for 2001. The Analytics, EER, Ship Analytics, SY Technologies, Telos and TMA acquired businesses contributed \$210.9 million of the increase in sales. Excluding these acquisitions, sales declined \$1.4 million or 0.2%. Sales for ballistic missile targets and services at our Coleman Research business declined \$53.0 million primarily because of a contract completed in 2002 and the delay in the award of its follow-on contract, which is related to the U.S. Missile Defense Agency's decision to consolidate the target requirements for all of its major missile defense programs into a single contract for fiscal year 2003. The decline in ballistic missile targets and services was largely offset by volume increases for training services from new contracts with the DoD, contracts competitively awarded during 2001 and software and systems engineering services. We expect that the sales growth, excluding acquisitions, for our training, simulation and support services will be between 6% and 7% in 2003, which is consistent with the overall increase in the DoD budget. We also expect our sales of ballistic missile targets and services to increase in 2003.

Operating income increased by \$30.8 million to \$96.5 million for 2002 from \$65.7 million for 2001 because of higher sales and operating margin. Operating margin increased by 1.0 percentage points to 12.0% for 2002 compared to 11.0% for 2001 principally because of the impact of not amortizing goodwill.

Aviation Products & Aircraft Modernization

Sales for the Aviation Products & Aircraft Modernization segment increased \$469.7 million to \$733.0 million for 2002 from \$263.3 million for 2001. The IS-Aircraft Modification and Maintenance (AMM) and Spar acquired businesses contributed \$502.0 million to sales. Excluding acquisitions, sales declined \$32.3 million, or 12.3%, because of lower volumes for commercial aviation recorders and TCAS products that were partially offset by sales increases for military displays products and commercial maritime voyage recorders. The decline in commercial aviation products sales was caused by a decline in orders and customer-directed deferrals of deliveries stemming from the continued downturn in the commercial aircraft industry that began in 2001 and which remained

weak during 2002. Although we expect the commercial aviation markets to remain weak during 2003, we do not expect our sales of commercial products to decline in 2003 because of the introduction of our new T²CAS product, which we plan to begin shipping by the end of the first half of 2003, and higher volume for our maritime voyage recorders and transponders. We expect sales from our aircraft modification services, which are primarily performed for the DoD, to increase slightly during 2003.

Operating income increased by \$19.5 million to \$105.1 million for 2002 from \$85.6 million for 2001, because of higher sales from acquired businesses. Operating margin declined by 18.2 percentage points to 14.3% for 2002 from 32.5% for 2001. The impact of not amortizing goodwill increased operating margin by 1.1 percentage points. Lower volumes on TCAS and aviation recorders, increased development expenses for a terrain awareness warning system and a commercial displays product-line reduced operating margin by 5.5 percentage points. The remaining decrease in operating margin of 13.8 percentage points was principally attributable to margins from the IS-AMM and Spar acquired businesses, which averaged 12.0% and were lower than the segment operating margin for 2001. Margins for our aircraft modification businesses are lower than the margins for our commercial aviation products businesses, and the aircraft modification businesses generated 70.5% of the segment's sales for 2002 compared with only 5.7% for 2001, which reduced the overall margin for the entire segment as we expected.

Specialized Products

Sales for the Specialized Products segment increased \$437.3 million to \$1,474.1 million for 2002 from \$1,036.8 million for 2001. The BT Fuze, Detection Systems, Electron Devices, IMC, KDI, Ruggedized Command & Control, Wescam, Westwood and Wolf Coach acquired businesses contributed \$200.4 million of sales. Excluding these acquisitions, sales increased \$236.9 million or 22.8%. Sales of explosive detection systems used in airport security principally relating to a contract from the Transportation Security Administration contributed \$320.9 million of the increase in sales. Navigation and guidance products sales also increased by \$20.1 million. These increases to sales were partially offset by volume declines of \$17.3 million on naval power equipment arising from lower shipments caused by production capacity diverted to fixing quality

control problems, \$16.8 million on training devices because certain contracts were completed in 2002, \$15.9 million for acoustic undersea warfare products primarily arising from lower spares volume, and \$14.5 million for commercial static transfer switches because of the deterioration of the internet service provider market. The remaining decline of \$39.6 million was principally on microwave components and telemetry and space products arising from continued softness and declining demand in the space, broadband and wireless commercial communications markets. We expect that our sales for EDS in 2003 will decline to about \$175 million primarily because the initial build-out of EDS by TSA for major U.S. airports was completed in 2002. Excluding the decline in EDS in 2003, we expect the sales growth, excluding acquisitions, for our Specialized Products to be between 7% and 8%. The majority of the growth is expected for naval power equipment for which shipments should increase after fixing the production problems experienced during 2001 and 2002 and for navigation products and training devices because of continued strong demand and recent orders.

Operating income increased by \$56.3 million to \$148.3 million for 2002 from \$92.0 million for 2001 because of higher sales and operating margin. Operating margin improved by 1.2 percentage points to 10.1% for 2002 compared to 8.9% for 2001. The impact of not amortizing goodwill increased operating margin by 1.6 percentage points. Higher volumes for explosive detection systems caused an increase in operating margin of 2.6 percentage points. These increases were partially offset by declines in operating margin that was primarily related to lower volumes on naval power equipment, microwave components and training devices, and the absence in 2002 of a favorable performance adjustment recorded in 2001 on the AVCATT contract discussed below.

Year Ended December 31, 2001 Compared with Year Ended December 31, 2000

Consolidated sales increased \$437.3 million to \$2,347.4 million for 2001 compared with 2000. Sales from "Contracts, primarily U.S. Government" increased \$347.4 million to \$1,932.2 million for 2001 from \$1,584.8 million for 2000. The MPRI, Coleman, KDI and EER acquisitions contributed \$335.6 million of the sales increase in 2001. The remaining sales increase in 2001 was primarily attributable to volume

increases of (1) \$66.0 million on secure telephone equipment and secure data links, (2) \$21.2 million on training devices and services, (3) \$16.2 million on acoustic undersea warfare products and (4) \$4.4 million on airport security systems. These sales increases were partially offset by declines of \$56.7 million on naval power equipment due to lower shipments caused by production quality control problems and customer-directed reductions in delivery requirements, and volume declines of \$39.3 million primarily on telemetry and space products related to the continued decline in the telemetry, space and broadband markets. Sales from "Commercial, primarily products" increased \$89.9 million to \$415.2 million in 2001 from \$325.3 million in 2000. The increase in 2001 was primarily attributable to volume increases of (1) \$53.1 million on aviation products, (2) \$20.8 million in microwave components and (3) \$13.5 million from fixed wireless access products. The remaining change in sales was due to an increase in network support services, which was partially offset by declines primarily on telemetry and space products related to the continued decline in the commercial telemetry, space and broadband communications markets.

The total increase in costs and expenses of \$384.7 million to \$2,072.1 million for 2001 from \$1,687.4 million for 2000 is consistent with the increases in sales. For 2001, costs and expenses were \$1,699.6 million for "Contracts, primarily U.S. Government" and \$372.5 million for "Commercial, primarily products."

Operating income increased because of higher sales by \$52.6 million to \$275.3 million for 2001 compared with 2000. Operating income as a percentage of sales ("operating margin") remained unchanged at 11.7%. Operating margins improved at our Training, Simulation & Support Services segment, our Aviation Products & Aircraft Modernization segment and our Specialized Products segment. These margin improvements were offset by a margin decline at our Secure Communications & ISR segment. The change in operating margin for each of our segments is discussed below.

Interest expense decreased \$6.6 million to \$86.4 million for 2001 because of lower interest rates, changes in the components and levels of our debt, and savings of \$4.1 million from the interest rate swap agreements we entered into in July 2001 and November 2001. The interest rate swap agreements exchange the fixed interest rate of 8% on our \$200.0 million Senior Subordinated Notes due 2008 and the

fixed interest rate of 8 1/2% on our \$180.0 million Senior Subordinated Notes due 2008 to variable interest rates determined using the six month LIBOR rate. See “— Liquidity and Capital Resources.”

Interest and other income decreased \$2.6 million to \$1.8 million. Interest and other income for 2001 includes a net pre-tax gain of \$0.6 million (\$0.01 per diluted share), consisting of an after-tax gain of \$4.3 million from the sale of a 30% interest in ACSS to Thales Avionics and an after-tax charge of \$3.9 million to write down the carrying amount of an investment in common stock of a telecommunications company because the decline of its value was determined to be other than temporary. Also included in interest and other income for 2001 is a pre-tax charge of \$0.5 million to account for the increase, in accordance with SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*, in the fair value assigned to the embedded derivatives in our \$420.0 million 4% Senior Subordinated Convertible Contingent Debt Securities due 2011 (CODES), we sold in the fourth quarter of 2001 (See “— Liquidity and Capital Resources”), and a pre-tax loss of \$0.8 million from an equity method investment. Interest and other income for 2000 includes a net pre-tax gain of \$2.5 million (\$0.02 per diluted share), consisting of an after-tax gain of \$9.2 million from the sale of our interests in certain businesses and an after-tax charge of \$7.6 million on the write-down in the carrying amount of an investment in a telecommunications venture that is no longer a going concern, the carrying amount of an investment in a telecommunications equipment provider that was determined to be permanently impaired and a related intangible asset. Excluding these net gains from both 2001 and 2000, diluted EPS increased 25.9% to \$1.46 in 2001 from \$1.16 in 2000.

The income tax provision for 2001 is based on an effective income tax rate of 38.0% which declined slightly from the effective tax rate of 38.3% for 2000.

Basic earnings per share (EPS) grew 24.2% to \$1.54 for 2001 and diluted EPS grew 24.6% to \$1.47 for 2001. Diluted weighted-average common shares outstanding increased 22.2% for 2001, primarily because of the sale of our common stock in May 2001, and the dilutive effect of our Convertible Notes we sold in the fourth quarter of 2000. See “— Liquidity and Capital Resources.”

Secure Communications & ISR

Sales within our Secure Communications & ISR segment increased \$57.5 million, or 14.6%, to \$450.5 million for 2001 compared with 2000. The increase in sales was attributed to increased sales of \$46.4 million from secure telephone equipment due to an increase in demand for secure communications, and \$13.6 million from PrimeWave fixed wireless access products related to a contract for a customer in Argentina. The remaining net decrease in sales was principally attributable to a decline in communication subsystems for the International Space Station, which was partially offset by higher volume for secure data links.

Operating income decreased by \$22.1 million to \$32.0 million for 2001 from \$54.1 million for 2000 because of lower operating margins that were partially offset by higher operating income from higher sales. Operating margin declined 6.7 percentage points from 13.8% in 2000 to 7.1% in 2001. Negative contract margins and increased SG&A and development expenditures and bad debt provisions associated with our PrimeWave business reduced operating margin by 3.7 percentage points. Volume declines and cost overruns related to design and manufacturing problems on certain signal collection and processing equipment reduced operating margin by 1.7 percentage points. The remaining decline in operating margin was principally attributable to lower volumes on certain military communication systems programs caused by contract deliveries that were completed or approaching completion in 2001. The declines were partially offset by higher operating margins on secure telephone equipment attributable to increased volumes and cost improvements.

Training, Simulation & Support Services

Sales within our Training, Simulation & Support Services segment increased \$313.4 million, or 110.6%, to \$596.8 million for 2001 compared with 2000. The Coleman, MPRI, and EER acquisitions contributed \$277.0 million of the increase in sales. The remaining increase in sales was attributable to various training, simulation and communications software support services.

Operating income increased by \$42.2 million to \$65.7 million for 2001 because of higher sales and operating margins. Operating margin increased 2.7 percentage points from 8.3% in 2000 to 11.0% for 2001. Volume increases and

cost improvements from the Link Training Services business increased operating margin by 1.6 percentage points. The remaining increase was principally attributable to higher margins from acquired businesses.

Aviation Products and Aircraft Modernization

Sales within our Aviation Products & Aircraft Modernization segment increased \$54.2 million, or 25.9%, to \$263.3 million for 2001 compared with 2000. Volume increased \$44.9 million on TCAS products and was attributable to increased customer demand and the timing of the TCAS acquisition completed in April 2000. Volume also increased by \$8.2 million for aviation recorders because of commercial customer retrofit deliveries. The remaining increase was primarily attributable to the Spar Aerospace business acquired in November 2001 offset by volume declines of \$8.7 million for displays sold to military customers related to the timing of contractual shipments.

Operating income increased by \$18.7 million to \$85.6 million for 2001 from \$66.9 million for 2000 primarily because of higher sales. Operating margin increased 0.5 percentage points from 32.0% for 2000 to 32.5% for 2001. Operating margin increased by 5.2 percentage points because of higher volume of TCAS products with higher gross margin contributions. Lower margins on display products related to volume declines reduced operating margin by 3.3 percentage points. Lower margins from the Spar Aerospace acquired business, which we expected, caused the remaining change in the operating margin.

Specialized Products

Sales within our Specialized Products segment increased \$12.2 million, or 1.2%, to \$1,036.8 million for 2001 compared with 2000. The increase in sales was principally attributable to the KDI acquired business and increases in volume for microwave components and acoustic undersea warfare products, partially offset by decreases in sales of telemetry and space products and naval power equipment.

Operating income increased by \$13.8 million for 2001 to \$92.0 million because of higher operating margin. Operating margin increased 1.3 percentage points to 8.9% for 2001 from 7.6% for 2000. Reductions in contract costs related to favorable performance on the AVCATT contract, arising from engineering design changes, material sourcing changes and unit price reductions on several parts in the contract bill of materials that

occurred during 2001 increased operating margin by 1.3 percentage points. Cost improvements from increased volume and product sales mix on microwave components resulted in an increase of 1.0 percentage points. Higher margins from fuzing products resulted in an increase of 0.7 percentage points. The remaining increase in operating margin was primarily attributable to overhead cost reductions and other cost improvements for training devices, volume increases for explosive detection systems and reduced losses on voice and data communication products. These improvements in operating margin were partially offset by continued unfavorable performance on certain contracts and lower production levels for naval power equipment which caused a decrease of 3.2 percentage points in operating margin.

Pension Plans

We maintain defined benefit pension plans covering employees at certain of our businesses. At December 31, 2002, our balance sheet included an aggregate \$205.1 million liability for pension benefits, an increase of \$142.8 million from \$62.3 million at December 31, 2001. The increase was primarily caused by the \$77.1 million of pension liabilities that we assumed as part of the IS acquisition and the increase in the minimum liability of \$75.4 million. Our total estimated projected benefit obligation, including projected future salary increases for covered employees was \$713.9 million at the end of 2002, and exceeded the fair value of our pension plan assets of \$431.8 million by \$282.1 million. The difference between this amount and the pension liability recorded on our balance sheet of \$205.1 million is attributable to the deferred recognition of actuarial gains and losses and accumulated differences between the assumed and actual rates of return on plan assets which increased by \$115.2 million to \$184.9 million from \$69.7 million. During 2002, our pension plan assets experienced a loss of \$27.8 million, primarily due to the declines in equity capital markets while the expected rate of return on plan assets which was included in the determination of pension cost was \$40.7 million, a difference of \$68.5 million. In addition, \$50.0 million of the increase in our benefit obligation resulted from changes in the actuarial assumptions and differences between actuarial assumptions and actual results. In accordance with SFAS No. 87, *Employer's Accounting for Pensions*, unrecognized losses that our pension plans experienced in 2002 were not included

in pension expense for 2002. Instead, they will be amortized to pension expense in future years over the estimated average remaining service periods of the covered employees (See Notes 3 and 16 to our consolidated financial statements).

Our pension expense for 2002 was \$41.9 million. We expect pension expense for 2003 to increase by a non-cash amount of between \$20.0 million and \$25.0 million over our 2002 pension expense, primarily because of the amortization of unrecognized losses through December 31, 2002, and the reductions that we made in 2002 to our discount rate from 7.25% to 6.75% and rate of return on plan assets from 9.5% to 9.0%. We made pension plan contributions for the full year 2002 of \$47.4 million, which exceeded our original planned contributions for 2002 by more than \$30 million. We expect to make pension plan contributions of between \$40 million and \$50 million in 2003. A substantial portion of our pension plan contributions for L-3's businesses that are U.S.

Government contractors are recoverable as allowable indirect contract costs at amounts generally equal to the annual pension contributions. Our actual pension expense for 2003 will be based upon a number of other factors, including the effect of any additional acquisitions for which we assume liabilities for pension benefits, actual pension plan contributions and changes (if any) to our pension assumptions for 2003, including the discount rate, asset return rate and salary increases.

Our shareholders' equity at December 31, 2002, reflects a non-cash charge of \$45.6 million (net of tax) to record the increase for the year ended December 31, 2002 in the minimum pension liability in accordance with SFAS No. 87. This non-cash charge had no effect on our compliance with the financial covenants of our debt agreements and did not impact our results of operations for 2002.

Liquidity and Capital Resources

Balance Sheet

Contracts in process increased \$516.2 million to \$1,318.0 million at December 31, 2002 from \$801.8 million at December 31, 2001. The increase included \$441.2 million related to acquired businesses and \$75.0 million principally from:

- increases of \$98.0 million in billed receivables due to higher sales for aircraft modifications, explosive detection systems, secure communications equipment and ISR systems;
- increases of \$2.1 million in unbilled contract receivables, net of unliquidated progress payments, due to higher sales

from explosive detection systems, ISR systems, secure data links, training devices and fuzing products, partially offset by shipments of ocean products and display systems as well as higher billings of aircraft modifications and training and support services;

- decreases of \$8.7 million in inventoried contract costs due to liquidations of aircraft modifications and secure terminal equipment inventories, partially offset by increases for naval power equipment, secure data links, ocean products and fuzing products; and
- decreases of \$16.4 million in inventories recorded at lower of cost or market due to declines for PrimeWave and security systems that were partially offset by increases for aviation products.

L-3's days sales outstanding (DSO) was 68.9 at December 31, 2002 compared with 80.4 at December 31, 2001. We calculate our DSO by dividing (a) our aggregate end of period billed receivables and net unbilled contract receivables, by (b) our sales for the last twelve-month period adjusted on a pro forma basis for the acquisitions that we completed as of the end of the period, divided by 365. Our DSO increased to 94.3 for the twelve-month period ended March 31, 2002 primarily because of the IS business, which we acquired on March 8, 2002, and remained relatively constant at 93.7 for June 30, 2002 and 90.2 for September 30, 2002. L-3's DSO declined substantially in the fourth quarter of 2002 because of higher sales volume and the final purchase price allocation adjustments for the IS acquisition. Excluding the IS acquisition, L-3's DSO would have been 79.2 at December 31, 2002.

Included in contracts in process at December 31, 2002 are net billed receivables of \$11.4 million and net inventories of \$18.2 million for our PrimeWave business. At December 31, 2001, we had \$15.8 million of net billed receivables and \$30.2 million of net inventories related to our PrimeWave business.

The increase in property, plant and equipment (PP&E) during 2002 was principally related to the acquisition of IS. The percentage of depreciation expense to average gross PP&E declined to 13.0% for 2002 from 14.6% for 2001. The decline was attributable to (1) the impact from current acquisitions, for which the balance sheet reflects all of the PP&E of the acquired businesses, but the statement of operations only includes depreciation expense from the date of

acquisition rather than for the entire period, and (2) fully depreciated PP&E used in certain of our operations despite having net carrying amounts of zero (after accumulated depreciation) and which are not removed from the balance sheet until they are retired or otherwise disposed of.

Goodwill increased \$1,086.8 million to \$2,794.5 million at December 31, 2002 from \$1,707.7 million at December 31, 2001. The increase was principally due to acquisitions with the largest increase for the IS acquired business.

The increases in accrued employment costs and accrued interest were primarily due to the timing of payments, as well as our acquisitions completed in 2002. The increases in accounts payable, accrued expenses, other current liabilities and pension and postretirement liabilities were primarily due to our acquisitions completed in 2002. The increase in other current liabilities was partially offset by the payment in January 2002 of \$43.6 million for the remaining outstanding common stock of Spar that was not tendered to L-3 as of December 31, 2001. The increase in postretirement liabilities was also attributable to an increase of \$75.4 million in our additional minimum pension liability, as discussed above. The increase in other liabilities was primarily due to notes payables assumed in connection with our acquisitions completed in 2002, and the deferred gain portion of cash proceeds received upon termination of the interest rate swap transactions we entered in 2002 and 2001, as discussed below.

Statements of Cash Flows

Our cash position at December 31, 2002 was \$134.9 million, \$361.0 million at December 31, 2001 and \$32.7 million at December 31, 2000. The table below provides a summary of our cash flows for the periods indicated.

(in millions)	Year ended Dec 31,		
	2002	2001	2000
Net cash from operating activities	\$ 318.5	\$ 173.0	\$ 113.8
Net cash used in investing activities	(1,810.5)	(424.9)	(608.2)
Net cash from financing activities	1,265.9	580.3	484.3
Net increase (decrease) in cash	\$ (226.1)	\$ 328.4	\$ (10.1)

Operating Activities

We generated \$318.5 million of cash from our operating activities during 2002, an increase of \$145.5 million from the \$173.0 million generated during 2001. Earnings adjusted for non-cash expenses for 2002 and deferred income taxes

increased \$126.0 million to \$409.5 million in 2002 from \$283.5 million in 2001. Deferred income taxes for 2002 compared with 2001 increased primarily because of larger estimated tax deductions arising from our recently completed acquisitions, including our acquisition of IS. Other non-cash items consist primarily of contributions of common stock to savings plans. During 2002, our working capital and operating assets and liabilities increased \$91.0 million, compared with an increase of \$110.5 million in 2001. Our cash flows from operating activities during 2002 reflect increases in billed and unbilled receivables, other current assets and other assets. The use of cash related to customer advances was due to liquidations on certain foreign contracts. The use of cash for other current liabilities was to fund contracts in a loss position for which estimated costs exceed the estimated billings, and was partially offset by an increase in accrued warranty costs primarily for explosive detection systems delivered in 2002. The timing of payments to employees for salaries and wages, as well as the timing of interest payments, was a source of cash. The source of cash in other liabilities was primarily due to deferred gains on the termination of our swap agreements, discussed below. Pension plan contributions in 2002 amounted to \$47.4 million.

During 2001, we generated \$173.0 million of cash from our operating activities, an increase of \$59.2 million from the \$113.8 million generated during 2000. Earnings adjusted for non-cash items and deferred income taxes increased \$83.2 million to \$283.5 million in 2001 from \$200.3 million in 2000. During 2001, our working capital and operating assets and liabilities increased \$110.5 million compared with an increase of \$86.5 million in 2000.

In 2001, we used cash for increases in inventories, receivables and negative operating margins related to our PrimeWave business and naval power equipment products, as well as for incurred contract costs in excess of billings for the continued effort on the AVCATT contract. These uses of cash were partially offset by a settlement of certain items related to a services agreement and lower income tax payments.

Our cash from operating activities includes interest payments on debt of \$109.3 million for 2002, \$81.6 million for 2001, and \$81.4 million for 2000. Our interest expense also includes amortization of deferred debt issue costs which is a non-cash expense.

Our cash from operating activities includes income tax payments, net of refunds of \$2.1 million for 2002, \$4.9 million for 2001, and \$10.1 million for 2000. Our income tax payments were substantially less than our provisions for income taxes reported on our statements of operations primarily because of income tax benefits arising from our acquisitions, as well as reductions to current income taxes payable for compensation expense tax deductions arising from the exercise of employee stock options which are credited directly to shareholders' equity and excluded from income (see Note 13 to our consolidated financial statements). Specifically, the difference of \$115.8 million between our income tax payments during 2002 and our provision for income taxes for the year ended December 31, 2002 is comprised of deferred income tax provisions of \$79.1 million, \$13.3 million of employee stock options compensation expense tax deductions and an increase of \$23.4 million to our accrued income taxes, net of certain reclassifications of deferred income tax assets and liabilities.

L-3 receives substantial income tax deductions from its acquisitions of businesses that are structured as asset purchases for income tax purposes. The effect of these income tax deductions is that our cash payments for income taxes are less than our provision for income taxes reported on the statement of operations. The difference is presented as deferred income tax provisions on our statement of cash flows. The deferred income tax provisions primarily result from deducting goodwill amortization from the "asset" acquisitions on L-3's income tax returns over 15 years, in accordance with tax rules and regulations, while no amortization is recorded for financial reporting purposes, in accordance with SFAS No. 142. One of the impacts of SFAS No. 142 was an increase to these income tax benefits because prior to adopting the provisions of SFAS No. 142, goodwill was also amortized for financial reporting purposes, although over longer periods of generally 40 years. We expect that the acquisitions L-3 has completed through December 31, 2002, excluding any additional acquisitions, will continue to generate deferred tax benefits, from 2003 to 2016, with amounts for 2003 to 2005 approximating L-3's deferred tax benefits for 2002. While these income tax deductions are reported as increases or decreases to deferred income tax liabilities and assets, they are not differences that are scheduled to reverse in future periods through normal operations. Rather, they will only

reverse if L-3 sells its acquired businesses. Presently, L-3 has no plans to make any material dispositions of its acquired businesses.

Investing Activities

During 2002, we invested \$1,742.1 million to acquire businesses, including IS, Detection Systems, Telos, ComCept, TMA, Electron Devices, Ruggedized Command & Control, Wolf Coach, IMC, Westwood, Wescam and Ship Analytics, and \$43.6 million for the remaining outstanding common stock of Spar which was not tendered to L-3 at December 31, 2001. The cash invested in acquisitions for 2002 also includes acquisition costs and payments for contingent purchase price and closing date net assets or net working capital purchase price adjustments for certain acquisitions completed prior to 2002. During 2001, we invested \$446.9 million to acquire businesses. During 2000, we invested \$599.6 million to acquire businesses.

The IS acquisition was financed using approximately \$229.0 million of cash on hand, borrowings under our senior credit facilities of \$420.0 million and a \$500.0 million senior subordinated bridge loan. We used a portion of the proceeds from the sale in June 2002 of \$750.0 million of senior subordinated notes and 14.0 million shares of common stock to repay borrowings under the senior credit facilities and the senior subordinated bridge loan as discussed below in Financing Activities. All of the other acquisitions were financed using cash on hand.

On May 31, 2001, we sold a 30% interest in ACSS to Thales Avionics for \$75.2 million in cash. In 2000, we sold our interests in two businesses for net cash proceeds of \$19.6 million. The cash proceeds from these transactions are included in other investing activities.

We make capital expenditures for the improvement of manufacturing facilities and equipment. We expect that our capital expenditures for the year ending December 31, 2003 will be between \$80 million and \$90 million.

Financing Activities

Debt

At December 31, 2002, the senior credit facilities were comprised of a \$500.0 million five-year revolving credit facility maturing on May 15, 2006 and a \$250.0 million 364-day revolving facility maturing on February 25, 2003 under which

at the maturity date we may, (1) at our request and subject to approval of the lenders, extend the maturity date, in whole or in part, for an additional 364-day period or (2) at our election, convert the outstanding principal amount thereunder into a term loan which would be repayable in a single payment two years from the conversion date. On February 25, 2003, the Company's lenders approved an extension of the maturity date of the 364-day revolving facility to February 24, 2004.

At December 31, 2002, available borrowings under our senior credit facilities were \$661.4 million, after reductions for outstanding letters of credit of \$88.6 million. There were no outstanding borrowings under our senior credit facilities at December 31, 2002.

In June 2002, L-3 Communications sold \$750.0 million of 7 5/8% Senior Subordinated Notes due June 15, 2012 (the "June 2002 Notes") with interest payable semi-annually on June 15 and December 15 of each year commencing December 15, 2002. The net proceeds from that offering amounted to \$731.8 million after underwriting discounts and commissions and other offering expenses.

The net proceeds from the June 2002 Notes and the simultaneous sale of 14.0 million shares of our common stock, discussed below under "— Equity," were used to (1) repay \$500.0 million borrowed on March 8, 2002, under our senior subordinated bridge loan facility, (2) repay the indebtedness outstanding under our senior credit facilities, (3) repurchase and redeem the 10 3/8% Senior Subordinated Notes due 2007 (discussed in the following paragraph) and (4) increase cash and cash equivalents.

On June 6, 2002 we commenced a tender offer to purchase any and all of our \$225.0 million aggregate principal amount of 10 3/8% Senior Subordinated Notes due 2007. The tender offer expired on July 3, 2002. On June 25, 2002 we sent a notice of redemption for all of our 10 3/8% Senior Subordinated Notes due 2007 that remained outstanding after the expiration of the tender offer. Upon sending the notice, the remaining notes became due and payable at the redemption price as of July 25, 2002. During 2002, we recorded a pre-tax extraordinary loss of \$16.2 million (\$9.9 million after-tax), comprised of premiums, fees and other transaction costs of \$12.5 million and \$3.7 million to write off the remaining balance of unamortized debt issue costs relating to these notes.

In the fourth quarter of 2001, L-3 Holdings sold \$420.0 million of 4% Senior Subordinated Convertible Contingent

Debt Securities due 2011 (CODES). The net proceeds from this offering amounted to approximately \$407.5 million after underwriting discounts and commissions and other offering expenses. Interest is payable semi-annually on March 15 and September 15 of each year commencing March 15, 2002. The CODES are convertible into L-3 Holdings' common stock at a conversion price of \$53.81 per share (7,804,878 shares) under any of the following circumstances: (1) during any Conversion Period (defined below) if the closing sales price of the common stock of L-3 Holdings is more than 120% of the conversion price (\$64.58) for at least 20 trading days in the 30 consecutive trading-day period ending on the first day of the respective Conversion Period, (2) during the five business-day period following any 10 consecutive trading-day period in which the average of the trading prices for the CODES was less than 105% of the conversion value, (3) if the credit ratings assigned to the CODES by either Moody's or Standard & Poor's are below certain specified ratings, (4) if they have been called for redemption by us, or (5) upon the occurrence of certain specified corporate transactions. A Conversion Period is the period from and including the thirtieth trading day in a fiscal quarter to, but not including, the thirtieth trading day of the immediately following fiscal quarter. There are four Conversion Periods in each fiscal year. Additionally, holders of the CODES have a right to receive contingent interest payments, not to exceed a per annum rate of 0.5% of the outstanding principal amount of the CODES, which will be paid on the CODES during any six-month period following a six-month period in which the average trading price of the CODES is above 120% of the principal amount of the CODES. The contingent interest payment provision was triggered for the period beginning September 15, 2002 to March 14, 2003 and resulted in additional interest for that period of \$0.8 million. The contingent interest payment provision as well as the ability of the holders of the CODES to exercise the conversion features as a result of changes in the credit ratings assigned to the CODES have been accounted for as embedded derivatives.

In the fourth quarter of 2000, L-3 Holdings sold \$300.0 million of 5 1/4% Convertible Senior Subordinated Notes due 2009 (the "Convertible Notes"). The net proceeds from this offering amounted to \$290.5 million after underwriting discounts and commissions and other offering expenses, and were used to repay revolver borrowings outstanding under our senior credit facilities. The Convertible Notes may be converted at any time into L-3 Holdings common stock at

a conversion price of \$40.75 per share (7,361,964 shares).

In June and August of 2002, we terminated the interest rate swap agreements we entered into in 2001 on \$380.0 million of our Senior Subordinated Notes due 2008 and received cash proceeds of \$9.3 million. In connection with the termination, we recorded a reduction in interest expense for 2002 of \$4.6 million, which represented the interest savings for the period prior to the termination of the swap agreements earned from the differences between the average variable interest rates of 4.6% that we paid under the swap agreements which were lower than the average fixed interest rate of 8.2% on the notes subject to the swaps. The remaining \$4.7 million represented the future value of the swap agreements at the termination date and was recorded as a deferred gain in accordance with SFAS No. 133 and will be amortized as a reduction of interest expense over the remaining terms of the \$380.0 million of Senior Subordinated Notes due 2008 at an amount equal to \$0.2 million per quarter, or \$0.8 million annually. We recorded an additional reduction of interest expense for 2002 of \$2.5 million relating to interest savings for interest periods which ended prior to the period during which we terminated the interest rate swap agreements. In June 2002, we entered into interest rate swap agreements on \$200.0 million of our 7 5/8% Senior Subordinated Notes due 2012. These swap agreements exchanged the fixed interest rate for a variable interest rate on \$200.0 million of the \$750.0 million principal amount outstanding. On September 30, 2002, we terminated these interest rate swap agreements and received cash proceeds of \$13.9 million in October 2002. In connection with the termination, we recorded a reduction of interest expense for 2002 of \$1.8 million, which represented interest savings based on the variable interest rate of 4.1% that L-3 paid in accordance with the terms of the swap for the period prior to the termination of these swap agreements. The remaining \$12.1 million represented the future value of the swap agreements at the termination date and was recorded as a deferred gain and will be amortized as a reduction of interest expense over the remaining term of the 7 5/8% Senior Subordinated Notes due 2012 at an amount of \$0.3 million per quarter, or \$1.3 million annually. All of the cash proceeds received from the swap agreements are included in cash from operating activities on L-3's statement of cash flows. L-3's earnings plan for 2002 included anticipated interest expense savings from the swap agree-

ments because we expected the variable rates payable on the swaps would be lower than the fixed interest rates on our senior subordinated notes. L-3 may enter into new interest rate swap agreements in the future if we believe that financial market conditions are favorable.

The senior credit facilities, senior subordinated notes, Convertible Notes and CODES agreements contain financial covenants and other restrictive covenants which remain in effect so long as we owe any amount or any commitment to lend exists thereunder. We are in compliance with those covenants in all material respects. The borrowings under the senior credit facilities are guaranteed by L-3 Holdings and by substantially all of the material domestic subsidiaries of L-3 Communications on a senior basis. The payments of principal and premium, if any, and interest on the senior subordinated notes are unconditionally guaranteed, on an unsecured senior subordinated basis, jointly and severally, by all of L-3 Communications' restricted subsidiaries other than its foreign subsidiaries. The guarantees of the senior subordinated notes are junior to the guarantees of the senior credit facilities and rank *pari passu* with each other and the guarantees of the Convertible Notes and the CODES. The Convertible Notes and CODES are unconditionally guaranteed, on an unsecured senior subordinated basis, jointly and severally, by L-3 Communications and substantially all of its direct and indirect material domestic subsidiaries. These guarantees rank junior to the guarantees of the senior credit facilities and rank *pari passu* with each other and the guarantees of the senior subordinated notes. The senior credit facilities also limit the payment of dividends by L-3 Communications to L-3 Holdings except for payment of franchise taxes, fees to maintain L-3 Holdings' legal existence, income taxes up to certain amounts, interest accrued on the Convertible Notes and CODES or to provide for operating costs of up to \$1.0 million annually. Under the covenant, L-3 Communications may also pay permitted dividends to L-3 Holdings from its excess cash, as defined, up to a cumulative amount of \$5.0 million, provided that the debt ratio is no greater than 3.5 to 1 as of the most recent fiscal quarter. As a result, at December 31, 2002, \$5.0 million of L-3 Communications net assets were available for payment of dividends to L-3 Holdings. See Note 8 to our consolidated financial statements for a description of our debt and related financial covenants at December 31, 2002.

Earnings before Interest, Taxes, Depreciation and Amortization (EBITDA)

Our EBITDA was \$529.9 million for 2002, \$362.3 million for 2001 and \$297.0 million for 2000. We define EBITDA as operating income plus depreciation expense and amortization expense. Other than our amount of debt and interest expense, EBITDA is the major component in the calculation of the debt ratio and interest coverage ratio which are part of the financial covenants for our debt. The debt ratio is defined as the ratio of consolidated total debt to consolidated EBITDA. The interest coverage ratio is equal to the ratio of consolidated EBITDA to consolidated cash interest expense. The higher our EBITDA is on a relative basis to our outstanding debt, the lower our debt ratio will be. A lower debt ratio indicates a higher borrowing capacity. Similarly, an increase in our EBITDA on a relative basis to consolidated cash interest expense results in a higher interest coverage ratio, which indicates a greater capacity to service debt.

EBITDA is presented as additional information because we believe it to be a useful indicator of an entity's debt capacity and its ability to service its debt. EBITDA is not a substitute for operating income, net income or cash flows from operating activities as determined in accordance with generally accepted accounting principles in the United States of America. EBITDA is not a complete net cash flow measure because EBITDA is a financial performance measurement that does not include reductions for cash payments for an entity's obligation to service its debt, fund its working capital and capital expenditures and pay its income taxes. Rather, EBITDA is one potential indicator of an entity's ability to fund these cash requirements. EBITDA as we defined it may differ from similarly named measures used by other entities and, consequently could be misleading unless all entities calculate and define EBITDA in the same manner. EBITDA is also not a complete measure of an entity's profitability because it does not include costs and expenses for depreciation and amortization, interest and income taxes.

Contractual Obligations and Contingent Commitments

The tables below present our contractual obligations and contingent commitments at December 31, 2002.

Contractual Obligations:

(in millions)	Total	Years Ending December 31,			
		2003	2004	2005	2006 and Thereafter
Principal amount of long-term debt	\$1,850.0	\$ —	\$ —	\$ —	\$1,850.0
Non-cancelable operating leases	565.1	71.3	64.6	80.7	348.5
Capital leases	2.2	0.7	0.8	0.5	0.2
Total	\$2,417.3	\$72.0	\$65.4	\$81.2	\$2,198.7

Contingent Commitments:

(in millions)	Total	Years Ending December 31,			
		2003	2004	2005	2006 and Thereafter
Outstanding letters of credit under our senior credit facilities	\$ 88.6	\$ 77.7	\$ 5.4	\$ 5.5	\$ —
Other outstanding letters of credit	71.1	65.7	0.7	0.2	4.5
Acquisition earnouts ⁽¹⁾	35.1	1.5	21.9	5.9	5.8
Guarantees of affiliate debt	1.0	1.0	—	—	—
Capital contributions for limited partnership investments	5.0	5.0	—	—	—
Total	\$200.8	\$150.9	\$28.0	\$11.6	\$10.3

(1) Represents contingent purchase price payments or "earnouts" for certain of our acquisitions that are contingent upon the post-acquisition financial performance of those acquired businesses. Any amount that we pay for the earnouts will be reported as cash paid for acquisition of business within investing activities on the statement of cash flows and will be recorded as an increase to goodwill for the acquisition.

Equity

On June 28, 2002, we sold 14.0 million shares of L-3 Holdings common stock in a public offering for \$56.60 per share. Upon closing, we received net proceeds of \$766.8 million after deducting underwriting discounts and commissions and other offering expenses. As mentioned above, the net proceeds from this sale and the simultaneous sale of the June 2002 Notes were used to (1) repay \$500.0 million borrowed on March 8, 2002, under our senior subordinated bridge loan facility, (2) repay the indebtedness outstanding under our senior credit facilities, (3) repurchase and redeem the 10 3/8% Senior Subordinated Notes due 2007 discussed above and (4) increase cash and cash equivalents.

On April 23, 2002, we announced that our Board of Directors had authorized a two-for-one stock split on all shares of our common stock. The stock split entitled all shareholders of record at the close of business on May 6, 2002 to receive one additional share of our common stock for every share held on that date. The additional shares were distributed to shareholders in the form of a stock dividend on May 20, 2002. Upon completion of the stock split, we had approximately 80 million shares of common stock outstanding.

On May 2, 2001, we sold 9.2 million shares of L-3 Holdings common stock in a public offering for \$40.00 per share. In addition, as part of the transaction, other selling stockholders, including affiliates of Lehman Brothers Inc., sold 4.7 million secondary shares. Upon closing, we received net proceeds of \$353.6 million, which we used to repay borrowings outstanding under our senior credit facilities, pay for the KDI and EER acquisitions and increase cash and cash equivalents.

Based upon our current level of operations, we believe that our cash from operating activities, together with available borrowings under the senior credit facilities, will be adequate to meet our anticipated requirements for working capital, capital expenditures, commitments, research and development expenditures, contingent purchase prices, program and other discretionary investments, and interest payments for the foreseeable future. There can be no assurance, however, that our business will continue to generate cash flow at current levels, or that currently anticipated improvements will be achieved. If we are unable to generate sufficient cash flow from operations to service our debt, we may be required to sell assets, reduce capital expenditures, refi-

nance all or a portion of our existing debt or obtain additional financing. Our ability to make scheduled principal payments or to pay interest on or to refinance our indebtedness depends on our future performance and financial results, which, to a certain extent, are subject to general conditions in or affecting the defense industry and to general economic, political, financial, competitive, legislative and regulatory factors beyond our control. There can be no assurance that sufficient funds will be available to enable us to service our indebtedness, to make necessary capital expenditures and to make discretionary investments.

Derivative Financial Instruments

Included in our derivative financial instruments are foreign currency forward contracts and the embedded derivatives related to the issuance of our CODES. All of our derivative financial instruments that are sensitive to market risk are entered into for purposes other than trading.

Embedded Derivatives. The contingent interest payment and contingent conversion features of the CODES are embedded derivatives which we bifurcated from the CODES and separately recorded on our balance sheet. On the date of issuance of the CODES, we ascribed \$2.5 million of the net proceeds from the CODES to those embedded derivatives which represented their aggregate fair value, and recorded it as a liability in accordance with SFAS No. 133. The subsequent increases (decreases) to the fair values of the embedded derivatives are recorded as losses (gains) in the statement of operations. Their fair values at December 31, 2002 were \$3.1 million, which represents a liability.

Interest Rate Risk. Our financial instruments that are sensitive to changes in interest rates include borrowings under the senior credit facilities all of which are denominated in U.S. dollars. There were no outstanding borrowings under our senior credit facilities. The interest rates on the senior subordinated notes, Convertible Notes and CODES are fixed-rate and are not affected by changes in interest rates. Depending on the interest rate environment we may enter into interest rate swap agreements to convert the fixed interest rates on our notes to variable interest rates or terminate any existing agreements. At December 31, 2002, we do not have any interest swap agreements in place.

When we enter into interest rate agreements, we attempt to manage exposure to counterparty credit risk

by only entering into agreements with major financial institutions that are expected to be able to fully perform under the terms of such agreements. Cash payments between us and the counterparties are made in accordance with the terms of the interest rate swap agreements. Such payments are recorded as adjustments to interest expense. Additional data on our debt obligations, our applicable borrowing spreads included in the interest rates we pay on borrowings under the senior credit facilities and interest rate agreements are provided in Notes 8 and 9 to our consolidated financial statements.

Foreign Currency Exchange Risk. We conduct some of our operations outside the U.S. in functional currencies other than the U.S. dollar. Additionally, some of our U.S. operations have contracts with foreign customers denominated in foreign currencies. To mitigate the risk associated with certain of these contracts denominated in foreign currency we have entered into foreign currency forward contracts. At December 31, 2002, the notional value of foreign currency forward contracts was \$6.0 million and the fair value of these contracts was \$0.5 million, which represents a liability. We account for these contracts as cash flow hedges.

Equity Price Risk. Our equity investments in common stocks and limited partnerships are subject to equity price risk. The fair values of our investments are based on quoted market prices, as available, and on historical cost for investments in cases in which it is not practicable to estimate fair value. Both the carrying values and estimated fair values of such instruments amounted to \$24.7 million at the end of 2002.

Backlog and Orders

We define funded backlog as the value of funded orders which have not yet been recognized as sales. We define funded orders as the value of contract awards received from the U.S. Government, for which the U.S. Government has appropriated funds, plus the value of contract awards and orders received from customers other than the U.S. Government. Our funded backlog as of December 31, 2002 was \$3,228.6 million and as of December 31, 2001 was \$1,719.3 million. We expect to record as sales approximately 73.0% of our December 31, 2002 funded backlog during 2003. However, there can be no assurance that our funded backlog will become sales in any particular period, if at all. Funded orders received were \$4,383.1 million for 2002, \$2,456.1 million for 2001 and \$2,013.7 million for 2000.

Our funded backlog does not include the full value of our contract awards including those pertaining to multi-year, cost-plus reimbursable contracts, which are generally funded on an annual basis. Funded backlog also excludes the sales value of unexercised contract options that may be exercised by customers under existing contracts and the sales value of purchase orders that we may receive under indefinite quantity contracts or basic ordering agreements.

Research and Development

Company-sponsored research and development costs, including bid and proposal costs were \$159.9 million for 2002, \$107.5 million for 2001 and \$101.9 million for 2000. Customer-funded research and development costs were \$480.9 million for 2002, \$319.4 million for 2001 and \$299.3 million for 2000.

Contingencies

We are engaged in providing products and services under contracts with the U.S. Government and, to a lesser degree, under foreign government contracts, some of which are funded by the U.S. Government. All such contracts are subject to extensive legal and regulatory requirements, and, periodically, agencies of the U.S. Government investigate whether such contracts were and are being conducted in accordance with these requirements. Under government procurement regulations, an indictment by a federal grand jury could result in the suspension for a period of time from eligibility for awards of new government contracts. A conviction could result in debarment from contracting with the federal government for a specified term. Additionally, in the event that U.S. Government expenditures for products and services of the type we manufacture and provide are reduced and not offset by greater commercial sales or other new programs or products or acquisitions, there may be a reduction in the volume of contracts or subcontracts awarded to us.

We continually assess our obligations with respect to applicable environmental protection laws. While it is difficult to determine the timing and ultimate cost to be incurred in order to comply with these laws, based upon available internal and external assessments, with respect to those environmental loss contingencies of which we are aware, we believe that even without considering potential insurance recoveries, if any, there are no environmental loss contingencies that, individually or in the aggregate, would be material

to our consolidated financial position, results of operations or cash flows. Also, we have been periodically subject to litigation, claims or assessments and various contingent liabilities incidental to our business. We accrue for these contingencies when it is probable that a liability has been incurred and the amount of the loss can be reasonably estimated.

In connection with the IS acquisition, we assumed responsibility for implementing certain corrective actions, required under federal law to remediate the Greenville, Texas site location, and to pay a portion of those remediation costs. The hazardous substances requiring remediation have been substantially characterized, and the remediation system has been partially implemented. We have estimated that our share of the remediation cost will not exceed \$2.5 million, and will be incurred over a period of 25 years. We have established adequate reserves for these costs.

On August 6, 2002, ACSS was sued by Honeywell International Inc. and Honeywell Intellectual Properties, Inc. (collectively, "Honeywell") for alleged infringement of patents that relate to terrain awareness avionics. The lawsuit was filed in the United States District Court for the District of Delaware. In December 2002, Honeywell withdrew without prejudice the lawsuit against ACSS and agreed to proceed with non-binding arbitration. If the matter is not resolved through arbitration, Honeywell may reinstitute the litigation after August 14, 2003. We had previously investigated the Honeywell patents and believe that ACSS has valid defenses against Honeywell's patent infringement suit. In addition, ACSS has been indemnified to a certain extent by Thales Avionics, which provided ACSS with the alleged infringing technology. Thales Avionics owns 30% of ACSS. In the opinion of management, the ultimate disposition of Honeywell's pending claim will not result in a material liability to us.

On November 18, 2002, we initiated a proceeding against OSI Systems, Inc. (OSI) in the United States District Court sitting in the Southern District of New York (the "New York action") seeking, among other things, a declaratory judgment that we had fulfilled all of our obligations under a letter of intent with OSI (the "OSI Letter of Intent"). Under the OSI Letter of Intent, we were to negotiate definitive agreements with OSI for the sale of certain businesses we acquired from PerkinElmer, Inc. on June 14, 2002. On December 23, 2002, OSI responded by filing suit against us in the United States District Court sitting in the Central District of California

(the "California action") alleging, among other things, that we breached our obligations under the OSI Letter of Intent and seeking damages in excess of \$100 million, not including punitive damages. On February 7, 2003, OSI filed an answer and counterclaims in the New York action that asserted substantially the same claims OSI had raised in the California action. We have filed a motion to have the California action dismissed in favor of the New York action. Under the OSI Letter of Intent, we proposed selling to OSI the conventional detection business and the ARGUS business that we recently acquired from PerkinElmer, Inc. Negotiations with OSI lasted for almost one year and ultimately broke down over issues regarding, among other things, intellectual property, product-line definitions, allocation of employees and due diligence. We believe that the claims asserted by OSI in its suit are without merit and intend to defend against the OSI claims vigorously.

With respect to those investigative actions, items of litigation, claims or assessments of which we are aware, we are of the opinion that the probability is remote that, after taking into account certain provisions that have been made with respect to these matters, the ultimate resolution of any such investigative actions, items of litigation, claims or assessments will have a material adverse effect on our consolidated financial position, results of operations or cash flows.

Recently Issued Accounting Standards

In August 2001, the FASB issued SFAS No. 143, *Accounting for Asset Retirement Obligations*. SFAS No. 143 applies to legal obligations associated with the retirement of tangible long-lived assets that result from the acquisition, construction, development or normal operation of a long-lived asset, except for certain obligations of lessees. This statement does not apply to obligations that arise solely from a plan to dispose of a long-lived asset. SFAS No. 143 requires that estimated asset retirement costs be measured at their fair values and recognized as assets and depreciated over the useful life of the related asset. Similarly, liabilities for the present value of asset retirement obligations are to be recognized and accreted as interest expense each year to their estimated future value until the asset is retired. These provisions will be applied to existing asset retirement obligations as of the adoption date as a cumulative effect of a change in accounting policy. SFAS No. 143 is effective for our fiscal years

beginning January 1, 2003. SFAS No. 143 is not expected to have a material effect on our consolidated results of operations and financial position.

In May 2002, the FASB issued SFAS No. 145, *Rescission of SFAS Nos. 4, 44 and 64, Amendment of SFAS No. 13, and Technical Corrections as of April 2002*. SFAS No. 145 rescinds SFAS No. 4, *Reporting Gains and Losses from Extinguishment of Debt*, and SFAS No. 64, *Extinguishments of Debt Made to Satisfy Sinking-Fund Requirements*. Under the provisions of SFAS No. 145, gains and losses from extinguishment of debt can only be classified as extraordinary items if they meet the criteria in APB Opinion No. 30. The provisions of this Statement related to the rescission of SFAS No. 4 shall be applied in fiscal years beginning after May 15, 2002. Earlier application is permitted. This statement also amends SFAS No. 13, *Accounting for Leases*, to eliminate an inconsistency between the accounting for sale-leaseback transactions and certain lease modifications that have economic effects that are similar and is effective for transactions occurring after May 15, 2002. This Statement also amends other existing authoritative pronouncements to make various technical corrections, clarify meanings, or describe their applicability under changed conditions and are effective for financial statements issued on or after May 15, 2002. SFAS No. 145 is not expected to have a material effect on our consolidated results of operations, financial position or cash flows. However, in accordance with the provisions of SFAS No. 145, beginning on January 1, 2003, the loss on the extinguishment of debt of \$16.2 million (\$9.9 million after-tax) that we recorded in June 2002 (see Note 8 to the consolidated financial statements) will be included in income from continuing operations and not be reported as an extraordinary item.

In July 2002, the FASB issued SFAS No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*. SFAS No. 146 replaces the FASBs' Emerging Issues Task Force (EITF) No. 94-3, *Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)*. SFAS No. 146 requires companies to recognize costs associated with exit or disposal activities when they are incurred rather than at the date of a commitment to an exit or disposal plan as was required by EITF No. 94-3. Examples of costs covered by SFAS No. 146 include lease termination costs and certain employee severance costs that are associated with a

restructuring, discontinued operation, plant closing, or other exit or disposal activity. SFAS No. 146 is to be applied to exit or disposal activities initiated after December 31, 2002. SFAS No. 146 is not expected to have a material effect on our consolidated results of operations and financial position.

In November 2002, the FASB issued FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others* (FIN 45). This interpretation addresses the disclosures to be made by a guarantor in its interim and annual financial statements about its obligations under guarantees and clarifies when a liability for the obligation undertaken should be recognized. The initial measurement of the liability is the fair value of the guarantee at its inception. This interpretation does not prescribe a specific account for the guarantor's offsetting entry when it recognizes the liability at the inception of a guarantee nor does it specify the subsequent measurement of the guarantors recognized liability. The initial recognition and measurement provisions shall be applied on a prospective basis to guarantees issued or modified after December 31, 2002. The disclosure requirements are included in Notes 6 and 15 to the consolidated financial statements. FIN 45 is not expected to have a material effect on our consolidated results of operations and financial position.

In December 2002, the FASB issued SFAS No. 148, *Accounting for Stock-Based Compensation — Transition and Disclosure — an amendment of FASB Statement No. 123*. This Statement amends FASB Statement No. 123, *Accounting for Stock-Based Compensation*, to provide alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. In addition, this Statement amends the disclosure requirements of Statement No. 123 to require prominent disclosures in both annual and interim financial statements about the method of accounting for stock-based employee compensation and the effect of the method used on reported results. The amendments to Statement No. 123 that relate to annual financial statements are effective for our 2002 annual financial statements. The amendments to Statement No. 123 that relate to interim financial statements are effective for our March 31, 2003 financial statements. We do not intend to adopt the fair value based method of accounting for stock-based employee compensation which would require us to record a non-cash

expense for the estimated fair value of stock-based compensation grants. Instead we will continue to apply the disclosure-only provisions of SFAS No. 123 (see Notes 2 and 14 to the consolidated financial statements). Therefore, SFAS No. 148 is not expected to have a material effect on our consolidated results of operations and financial position.

In January 2003, the FASB issued FASB Interpretation No. 46, *Consolidation of Variable Interest Entities* (FIN 46). This interpretation provides guidance on the identification of, and financial reporting for, entities over which control is achieved through means other than voting rights. Such entities have been termed by FIN 46 as variable interest entities (VIE). Once effective, FIN 46 will be the guidance that determines (1) whether consolidation is required under the "controlling financial interest" model of ARB Bulletin No. 51, *Consolidated Financial Statements*, or (2) whether the variable-interest model under FIN 46 should be used to account for existing and new entities. FIN 46 includes guidance for identifying the enterprise that will consolidate a VIE, which is the enterprise that is exposed to the majority of an entity's risks or receives the majority of the benefits from an entity's activities. FIN 46 also requires that the enterprises that hold a significant variable interest in a VIE make new disclosures in their financial statements. The transitional disclosures of FIN 46, which are effective immediately, require an enterprise to identify the entities in which it holds a variable interest if the enterprise believes that those entities might be considered VIEs upon the adoption of FIN 46. The implementation and remaining disclosure requirements of FIN 46 are effective immediately for VIEs created after January 31, 2003, and on July 1, 2003, for all VIEs created before January 31, 2003. We do not believe that we hold any interests in VIEs, however, we are currently evaluating whether we hold a variable interest in entities that might be considered VIEs.

Inflation

The effect of inflation on our sales and earnings has not been significant. Although a majority of our sales are made under long-term contracts, the selling prices of such contracts, established for deliveries in the future, generally reflect estimated costs to be incurred in these future periods. In addition, some of our contracts provide for price adjustments through cost escalation clauses.

Forward-Looking Statements

Certain of the matters discussed concerning our operations, cash flows, financial position, economic performance, and financial condition, including in particular, the likelihood of our success in developing and expanding our business and the realization of sales from backlog, include forward-looking statements within the meaning of section 27A of the Securities Act and Section 21E of the Exchange Act.

Statements that are predictive in nature, that depend upon or refer to events or conditions or that include words such as "expects," "anticipates," "intends," "plans," "believes," "estimates" and similar expressions are forward-looking statements. Although we believe that these statements are based upon reasonable assumptions, including projections of orders, sales, operating margins, earnings, cash flow, research and development costs, working capital, capital expenditures and other projections, they are subject to several risks and uncertainties, and therefore, we can give no assurance that these statements will be achieved. Such statements will also be influenced by factors such as:

- our dependence on the defense industry and the business risks peculiar to that industry including changing priorities or reductions in the U.S. Government defense budget;
- our reliance on contracts with a limited number of agencies of, or contractors to, the U.S. Government and the possibility of termination of government contracts by unilateral government action or for failure to perform;
- our ability to obtain future government contracts on a timely basis;
- the availability of government funding and changes in customer requirements for our products and services;
- our significant amount of debt and the restrictions contained in our debt agreements;
- collective bargaining agreements and labor disputes;
- the business and economic conditions in the markets we operate in, including those for the commercial aviation and communications markets;
- economic conditions, competitive environment, international business and political conditions, timing of international awards and contracts;
- our extensive use of fixed-price contracts as compared to cost-reimbursable contracts;

- our ability to identify future acquisition candidates or to integrate acquired operations;
- the rapid change of technology and high level of competition in the communication equipment industry;
- our introduction of new products into commercial markets or our investments in commercial products or companies;
- pension, environmental or legal matters or proceedings and various other market, competition and industry factors, many of which are beyond our control; and
- the fair values of our assets including identifiable intangible assets and the estimated fair value of the goodwill balances for our reporting units which can be impaired or reduced by the other factors discussed above.

Readers of this document are cautioned that our forward-looking statements are not guarantees of future performance and the actual results or developments may differ materially from the expectations expressed in the forward-looking statements.

As for the forward-looking statements that relate to future financial results and other projections, actual results will be different due to the inherent uncertainties of estimates, forecasts and projections and may be better or worse than projected. Given these uncertainties, you should not place any reliance on these forward-looking statements. These forward-looking statements also represent our estimates and assumptions only as of the date that they were made. We expressly disclaim a duty to provide updates to these forward-looking statements, and the estimates and assumptions associated with them, after the date of this filing to reflect events or changes or circumstances or changes in expectations or the occurrence of anticipated events.

Consolidated Balance Sheets

(in thousands, except share data)	December 31,	
	2002	2001
Assets		
Current assets:		
Cash and cash equivalents	\$ 134,856	\$ 361,022
Contracts in process	1,317,993	801,824
Deferred income taxes	143,634	62,965
Other current assets	42,891	16,590
Total current assets	1,639,374	1,242,401
Property, plant and equipment, net	458,639	203,374
Goodwill	2,794,548	1,707,718
Intangible assets	90,147	3,833
Deferred income taxes	147,190	97,883
Deferred debt issue costs	48,839	40,190
Other assets	63,571	43,850
Total assets	\$5,242,308	\$3,339,249
Liabilities and Shareholders' Equity		
Current liabilities:		
Accounts payable, trade	\$ 167,240	\$ 129,538
Accrued employment costs	187,754	126,981
Accrued expenses	56,763	38,823
Customer advances	71,751	74,060
Accrued interest	20,509	13,288
Income taxes	33,729	16,768
Other current liabilities	158,893	125,113
Total current liabilities	696,639	524,571
Pension and postretirement benefits	343,527	155,052
Other liabilities	78,947	60,585
Long-term debt	1,847,752	1,315,252
Total liabilities	2,966,865	2,055,460
Commitments and contingencies		
Minority interest	73,241	69,897
Shareholders' equity:		
Common stock; \$.01 par value; authorized 300,000,000 shares, issued and outstanding 94,577,331 and 78,496,626 shares	1,794,976	939,037
Retained earnings	479,827	301,730
Unearned compensation	(3,302)	(3,205)
Accumulated other comprehensive loss	(69,299)	(23,670)
Total shareholders' equity	2,202,202	1,213,892
Total liabilities and shareholders' equity	\$5,242,308	\$3,339,249

See notes to consolidated financial statements.

Consolidated Statements of Operations

(in thousands, except per share data)	Year Ended December 31,		
	2002	2001	2000
Sales:			
Contracts, primarily U.S. Government	\$3,581,102	\$1,932,205	\$1,584,824
Commercial, primarily products	430,127	415,217	325,237
Total sales	4,011,229	2,347,422	1,910,061
Costs and expenses:			
Contracts, primarily U.S. Government	3,137,561	1,699,617	1,388,263
Commercial, primarily products:			
Cost of sales	270,800	252,790	204,989
Selling, general and administrative expenses	114,052	93,238	70,039
Research and development expenses	34,837	26,447	24,052
Total costs and expenses	3,557,250	2,072,092	1,687,343
Operating income	453,979	275,330	222,718
Interest and other income	4,921	1,739	4,393
Interest expense	122,492	86,390	93,032
Minority interest	6,198	4,457	—
Income before income taxes, extraordinary loss and cumulative effect of a change in accounting principle	330,210	186,222	134,079
Provision for income taxes	117,885	70,764	51,352
Income before extraordinary loss and cumulative effect of a change in accounting principle	212,325	115,458	82,727
Extraordinary loss on early extinguishment of debt, net of income taxes of \$6,329 (Note 8)	(9,858)	—	—
Cumulative effect of a change in accounting principle, net of income taxes of \$6,428 (Note 5)	(24,370)	—	—
Net income	\$ 178,097	\$ 115,458	\$ 82,727
Earnings per common share:			
Basic:			
Income before extraordinary loss and accounting change	\$ 2.44	\$ 1.54	\$ 1.24
Extraordinary loss	(0.11)	—	—
Accounting change	(0.28)	—	—
Net income	\$ 2.05	\$ 1.54	\$ 1.24
Diluted:			
Income before extraordinary loss and accounting change	\$ 2.29	\$ 1.47	\$ 1.18
Extraordinary loss	(0.11)	—	—
Accounting change	(0.25)	—	—
Net income	\$ 1.93	\$ 1.47	\$ 1.18
Weighted average common shares outstanding:			
Basic	86,943	74,880	66,710
Diluted	97,413	85,438	69,906

See notes to consolidated financial statements.

Consolidated Statements of Shareholders' Equity

For the Years Ended December 31, 2002, 2001 and 2000 (In thousands)	Common Stock Shares Issued	Par Value	Additional Paid-in Capital	Retained Earnings	Unearned Compensation	Accumulated Other Comprehensive Income (Loss)	Total
Balance December 31, 1999	65,590	\$655	\$ 483,039	\$103,545	\$(1,661)	\$ (2,403)	\$ 583,175
Comprehensive income:							
Net income				82,727			82,727
Minimum pension liability, net of (\$553) tax benefit						(819)	(819)
Foreign currency translation adjustment						(1,222)	(1,222)
Unrealized loss on securities, net of (\$2,316) tax benefit						(2,728)	(2,728)
							77,958
Shares issued:							
Employee savings plans	469	5	12,637				12,642
Exercise of stock options	1,154	12	18,050				18,062
Grant of restricted stock			1,512		(1,512)		—
Amortization of unearned compensation					716		716
Other			16				16
Balance December 31, 2000	67,213	672	515,254	186,272	(2,457)	(7,172)	692,569
Comprehensive income:							
Net income				115,458			115,458
Minimum pension liability, net of (\$11,955) tax benefit						(19,519)	(19,519)
Foreign currency translation adjustment, net of (\$164) tax benefit						(268)	(268)
Unrealized loss on securities, net of (\$111) tax benefit						(180)	(180)
Unrealized loss on securities reclassified to net income from other comprehensive loss, net of \$2,274 of taxes						3,632	3,632
Unrealized losses on hedging instruments, net of (\$100) tax benefit						(163)	(163)
							98,960
Shares issued:							
Sale of common stock	9,150	92	353,530				353,622
Employee savings plans	418	4	16,864				16,868
Acquisition consideration	588	6	17,351				17,357
Exercise of stock options	1,128	11	28,253				28,264
Employee stock purchase plan contributions			4,861				4,861
Grant of restricted stock			2,118		(2,118)		—
Amortization of unearned compensation					1,370		1,370
Other			21				21
Balance December 31, 2001	78,497	785	938,252	301,730	(3,205)	(23,670)	1,213,892
Comprehensive income:							
Net income				178,097			178,097
Minimum pension liability, net of (\$29,859) tax benefit						(45,580)	(45,580)
Foreign currency translation adjustment, net of (\$1,626) tax benefit						65	65
Unrealized losses on hedging instruments reclassified to net income from other comprehensive loss, net of \$198 of taxes						323	323
Unrealized losses on hedging instruments, net of (\$275) tax benefit						(437)	(437)
							132,468
Shares issued:							
Sale of common stock	14,000	140	766,640				766,780
Employee savings plans	529	5	28,133				28,138
Acquisition consideration	229	2	10,605				10,607
Exercise of stock options	970	10	30,665				30,675
Employee stock purchase plan contributions	352	4	17,474				17,478
Grant of restricted stock			2,231		(2,231)		—
Amortization of unearned compensation					2,134		2,134
Other			30				30
Balance December 31, 2002	94,577	\$946	\$1,794,030	\$479,827	\$(3,302)	\$(69,299)	\$2,202,202

See notes to consolidated financial statements.

Consolidated Statements of Cash Flows

(in thousands)	Year Ended December 31,		
	2002	2001	2000
Operating Activities:			
Net income	\$ 178,097	\$ 115,458	\$ 82,727
Extraordinary loss on early extinguishment of debt	9,858	—	—
Cumulative effect of a change in accounting principle	24,370	—	—
Goodwill amortization	—	42,356	34,994
Depreciation	66,230	40,362	36,158
Amortization of intangibles and other assets	9,630	4,233	3,102
Amortization of deferred debt issue costs (included in interest expense)	7,392	6,388	5,724
Minority interest	6,198	4,457	—
Deferred income tax provision	79,092	52,638	25,103
Other non-cash items, principally contributions to employee savings plans in L-3 Holdings' common stock	28,653	17,576	12,517
Changes in operating assets and liabilities, net of amounts acquired:			
Contracts in process	(75,031)	(40,652)	(66,402)
Other current assets	(15,257)	1,643	(2,599)
Other assets	(16,641)	(12,033)	(416)
Accounts payable	(21,904)	(43,165)	38,065
Accrued employment costs	30,100	11,931	6,239
Accrued expenses	(2,581)	(20,300)	2,274
Customer advances	(11,272)	12,627	(17,087)
Accrued interest	7,199	(3,047)	3,637
Income taxes	37,181	14,431	13,161
Other current liabilities	(41,206)	(37,555)	(59,286)
Pension and postretirement benefits	(1,670)	4,550	(7,214)
Other liabilities	20,517	1,423	1,959
All other operating activities	(495)	(353)	1,149
Net cash from operating activities	318,460	172,968	113,805
Investing Activities:			
Acquisition of businesses, net of cash acquired	(1,742,133)	(446,911)	(599,608)
Proceeds from sale of interest in subsidiary	—	75,206	—
Capital expenditures	(62,058)	(48,121)	(33,580)
Disposition of property, plant and equipment	3,548	1,237	18,060
Other investing activities	(9,885)	(6,301)	6,905
Net cash used in investing activities	(1,810,528)	(424,890)	(608,223)
Financing Activities:			
Borrowings under revolving credit facility	566,000	316,400	858,500
Repayment of borrowings under revolving credit facility	(566,000)	(506,400)	(668,500)
Borrowings under bridge loan facility	500,000	—	—
Repayment of borrowings under bridge loan facility	(500,000)	—	—
Proceeds from sale of senior subordinated notes	750,000	420,000	300,000
Redemption of senior subordinated notes	(237,468)	—	—
Proceeds from sale of common stock, net	766,780	353,622	—
Debt issuance costs	(19,759)	(16,671)	(12,916)
Proceeds from exercise of stock options	17,372	16,325	8,954
Employee stock purchase plan contributions	17,478	4,861	—
Distributions to minority interest	(2,854)	(2,530)	—
Other financing activities	(25,647)	(5,343)	(1,728)
Net cash from financing activities	1,265,902	580,264	484,310
Net increase (decrease) in cash	(226,166)	328,342	(10,108)
Cash and cash equivalents, beginning of period	361,022	32,680	42,788
Cash and cash equivalents, end of period	\$ 134,856	\$ 361,022	\$ 32,680

See notes to consolidated financial statements.

Notes to Consolidated Financial Statements

(Dollars in thousands, except per share data)

1. Description of Business

L-3 Communications Holdings, Inc. conducts its operations and derives all its operating income and cash flow through its wholly owned subsidiary, L-3 Communications Corporation ("L-3 Communications"). L-3 Holdings' only asset is its investment in the common stock of L-3 Communications. L-3 Communications Holdings, Inc. ("L-3 Holdings" and together with its subsidiaries, "L-3" or "the Company") is a merchant supplier of secure communications and intelligence, surveillance and reconnaissance (ISR) systems, training, simulation and support services, aviation products and aircraft modernization, as well as specialized products. The Company's customers include the U.S. Department of Defense (DoD) and prime contractors thereof, certain U.S. Government intelligence agencies, major aerospace and defense contractors, foreign governments, commercial customers and certain other U.S. federal, state and local government agencies. The Company has the following four reportable segments: (1) Secure Communications & ISR; (2) Training, Simulation & Support Services; (3) Aviation Products & Aircraft Modernization; and (4) Specialized Products.

Secure Communications & ISR. The businesses in this segment provide products and services for the global ISR market, specializing in signals intelligence (SIGINT) and communications intelligence (COMINT) systems. These products and services provide to the warfighter in real time the unique ability to collect and analyze unknown electronic signals from command centers, communication nodes and air defense systems for real-time situation awareness and response. This segment also provides secure, high data rate communications systems for military and other U.S. Government and foreign government reconnaissance and surveillance applications. These systems and products are critical elements of virtually all major communication, command and control, intelligence gathering and space systems. The Company's systems and products are used to connect a variety of airborne, space, ground and sea-based communication systems and are used in the transmission, processing, recording, monitoring and dissemination functions of these communication systems. The major secure communication programs and systems include:

- secure data links for airborne, satellite, ground and sea-based remote platforms for real-time information collection and dissemination to users;
- highly specialized fleet management and support, including procurement, systems integration, sensor development, modifications and maintenance for signals intelligence and ISR special mission aircraft and airborne surveillance systems;
- strategic and tactical signals intelligence systems that detect, collect, identify, analyze and disseminate information;
- secure telephone and network equipment and encryption management; and
- communication systems for surface and undersea vessels and manned space flights.

Training, Simulation & Support Services. The businesses in this segment provide a full range of training, simulation and support services, including:

- services designed to meet customer training requirements for aircrews, navigators, mission operators, gunners and maintenance technicians for virtually any platform, including military fixed and rotary wing aircraft, air vehicles and various ground vehicles;
- communication software support, information services and a wide range of engineering development services and integration support;
- high-end engineering and information support services used for command, control, communications and ISR architectures, as well as for air warfare modeling and simulation tools for applications used by the DoD, Department of Homeland Security and U.S. Government intelligence agencies, including missile and space systems, Unmanned Aerial Vehicles (UAVs) and military aircraft;
- developing and managing extensive programs in the United States and internationally that focus on teaching, training and education, logistics, strategic planning, organizational design, democracy transition and leadership development;
- producing crisis management software and providing command and control for homeland security applications; and
- design, prototype development and production of ballistic missile targets for missile defense applications, including present and future threat scenarios.

Aviation Products & Aircraft Modernization. The businesses in this segment provide aviation products and aircraft modernization services, including:

- airborne traffic and collision avoidance systems (TCAS) for commercial and military applications;
- commercial, solid-state, crash-protected cockpit voice recorders, flight data recorders and maritime hardened voyage recorders;
- ruggedized custom displays for military and high-end commercial applications;
- turnkey aviation life cycle management services that integrate custom developed and commercial off-the-shelf products for various military and commercial wide-body and rotary wing aircraft, including heavy maintenance and structural modifications and Head-of-State and commercial interior completions; and
- engineering, modification, maintenance, logistics and upgrades for U.S. Special Operations Command aircraft, vehicles and personnel equipment.

Specialized Products. The businesses in this segment supply products, including components, subsystems and systems, to military and commercial customers in several niche markets. These products include:

- ocean products, including acoustic undersea warfare products for mine hunting, dipping and anti-submarine sonars and naval power distribution, conditioning, switching and protection equipment for surface and undersea platforms;
- ruggedization and integration of commercial off-the-shelf technology for displays, computers and electronic systems for military and commercial applications;
- integrated video security and surveillance systems that provide perimeter security used by the U.S. Immigration and Naturalization Service and U.S. Border Patrol to monitor and protect U.S. borders;
- security systems for aviation, port and border applications to detect explosives, concealed weapons, contraband and illegal narcotics, to inspect agricultural products and to examine cargo;
- telemetry, instrumentation, space and navigation products, including tracking and flight termination;
- premium fuzing products;
- microwave components used in radar communication satellites, wireless communication equipment, electronic surveillance, communication and electronic warfare applications and countermeasure systems;

- high performance antennas and ground based radomes;
- training devices and motion simulators which produce advanced virtual reality simulation and high-fidelity representations of cockpits and mission stations for fixed and rotary wing aircraft and land vehicles; and
- precision stabilized electro-optic surveillance systems, including high magnification lowlight, daylight and forward looking infrared sensors, laser range finders, illuminators and designators, and digital and wireless communication systems.

2. Summary of Significant Accounting Policies

Sales and Costs and Expenses Presentation: The

Company presents its sales and cost and expenses in two categories in the statement of operations, “Contracts, primarily U.S. Government” and “Commercial, primarily products,” which are based on how the Company recognizes revenue. Sales and costs and expenses for the Company’s businesses that are primarily U.S. Government contractors are presented as “Contracts, primarily U.S. Government.” The sales for the Company’s U.S. Government contractor businesses are transacted using written contractual arrangements or “contracts” for products and services according to the specifications of the customer and are within the scope of the American Institute of Certified Public Accountants Statement of Position 81-1, *Accounting for Performance of Construction-Type and certain Production-Type Contracts* (SOP 81-1) and Accounting Research Bulletin No. 43, Chapter 11, Section A, *Government Contracts, Cost-Plus-Fixed Fee Contracts* (ARB 43). Sales reported under “Contracts, primarily U.S. Government” also include certain sales by the Company’s U.S. Government contractor businesses transacted using contracts for domestic and foreign commercial customers which also are within the scope of SOP 81-1. Sales and costs and expenses for the Company’s businesses whose customers are primarily commercial customers are presented as “Commercial, primarily products.” These sales to commercial customers are not within the scope of SOP 81-1 or ARB 43, and are recognized in accordance with the SEC’s SAB No. 101, *Revenue Recognition in Financial Statements*. The Company’s commercial businesses are substantially comprised of Aviation Communication & Surveillance Systems (ACSS), Aviation Recorders, Microwave components, the Detection Systems business acquired from PerkinElmer, Inc., Satellite Networks, and PrimeWave Communications.

During 2002, certain commercial businesses of L-3 were combined with other larger L-3 businesses, which are primarily U.S. Government contractors. Sales and costs and expenses for these commercial businesses are now presented under the caption "Contracts, primarily U.S. Government." The Company has reclassified sales and costs and expenses for all prior periods presented to conform to the 2002 presentation.

Principles of Consolidation: The consolidated financial statements of the Company include all wholly-owned and significant majority-owned subsidiaries. All significant inter-company transactions are eliminated in consolidation. Investments over which the Company has significant influence but does not have voting control are accounted for by the equity method.

Cash and Cash Equivalents: Cash equivalents consist of highly liquid investments with a maturity of three months or less at time of purchase.

Revenue Recognition: The substantial majority of the Company's direct and indirect sales to the U.S. Government and certain of the Company's sales to foreign governments and commercial customers are made pursuant to written contractual arrangements or "contracts" to design, develop, manufacture and/or modify complex products, and to the specifications of the buyers (customers) or to provide services related to the performance of such contracts. These contracts are within the scope of SOP 81-1, and sales and profits on them are recognized using percentage-of-completion methods of accounting. Sales and profits on fixed-price production contracts whose units are produced and delivered in a continuous or sequential process are recorded as units are delivered based on their selling prices (the "units-of-delivery" method). Sales and profits on other fixed-price contracts are recorded based on the ratio of total actual incurred costs to date to the total estimated costs for each contract (the "cost-to-cost method"). Amounts representing contract change orders or claims are included in sales only when they can be reliably estimated and their realization is reasonably assured. Losses on contracts are recognized in the period in which they are determined. The impact of revisions of contract estimates, which may result from contract modifications, performance or other reasons, are recognized on a cumulative catch-up basis in the period in which the revisions are made.

Revenue recognition on sales arrangements that are cost-reimbursable contracts with the U.S. Government are also specifically within the scope of ARB 43, in addition to SOP 81-1. Sales and profits on a cost-reimbursable contract are recognized as allowable costs are incurred on the contract and become billable to the customer, in an amount equal to the allowable costs plus the profit on those costs which is generally fixed or variable based on the contract fee arrangement.

Sales on arrangements that are not within the scope of SOP 81-1 or ARB 43 are recognized in accordance with the SEC's SAB No. 101. Sales are recognized when there is persuasive evidence of an arrangement, delivery has occurred or services have been performed, the selling price to the buyer is fixed or determinable and collectibility is reasonably assured.

Contracts in Process: Contracts in process include receivables and inventories for contracts that are within the scope of SOP 81-1, as well as receivables and inventories related to other contractual arrangements. Billed Receivables represent the uncollected portion of amounts recorded as sales and billed to customers, including those amounts for sales arrangements that are not within the scope of SOP 81-1. Unbilled Contract Receivables represent accumulated incurred costs and earned profits or losses on contracts in process that have been recorded as sales, but have not yet been billed to customers. Inventoried Contract Costs represent incurred costs on contracts in process that have not been recognized as costs and expenses and which are recoverable under contracts. Incurred contract costs include direct costs and overhead costs. In accordance with SOP 81-1 and the AICPA Audit and Accounting Guidelines, *Audits of Federal Government Contractors*, the Company's inventoried contract costs for U.S. Government contracts, and contracts with prime contractors or subcontractors of the U.S. Government, also include allocated general and administrative costs, independent research and development costs and bid and proposal costs. Contracts in Process may contain amounts relating to contracts and programs with long performance cycles, a portion of which may not be realized within one year. Provisions for contracts in a loss position in excess of the amounts included in Contracts in Process are reported in Estimated Costs in Excess of Billings to Complete Contracts in Process, which is a component of Other Current Liabilities and Other Liabilities. Under the contractual arrangements on certain contracts with the U.S. Government,

the Company receives progress payments as it incurs costs. The U.S. Government has a security interest in the Unbilled Contract Receivables and Inventoried Contract Costs to which progress payments have been applied, and such progress payments are reflected as a reduction of the related Unbilled Contract Receivables and Inventoried Contract Costs. Customer Advances are classified as current liabilities.

Inventories other than Inventoried Contract Costs are stated at the lower of cost or market primarily using the average cost method.

The Company values its acquired contracts in process on the date of acquisition at contract value less the Company's estimated costs to complete the contract and a reasonable profit allowance on the Company's completion effort commensurate with the profit margin that the Company earns on similar contracts.

Derivative Financial Instruments: In connection with its risk management and financial derivatives, the Company has entered into interest rate swap agreements, interest rate cap and floor contracts and foreign currency forward contracts. Derivative financial instruments also include embedded derivatives. The Company's interest rate swap agreements are accounted for as fair value hedges. The difference between the variable interest rates paid on the interest rate swap agreements and the fixed interest rate on the debt instrument underlying the swap agreements is recorded as increases or decreases to interest expense. Upon termination of an interest rate swap agreement, the cash received or paid that relates to the future value of the swap agreements at the termination date is a deferred gain or loss, which is recognized as a decrease or increase to interest expense over the remaining term of the underlying debt instrument. The foreign currency forward contracts are accounted for as cash flow hedges. Upon settlement, gains and losses on foreign currency forward contracts are reported as a component of the underlying transaction within contracts in process. The embedded derivatives related to the issuance of the Company's debt are recorded at fair value with changes reflected in the statement of operations.

Property, Plant and Equipment: Property, plant and equipment are stated at cost, less accumulated depreciation. Depreciation is computed by applying principally the straight-line method to the estimated useful lives of the related assets. Useful lives range substantially from 10 to 40 years

for buildings and improvements and 3 to 10 years for machinery, equipment, furniture and fixtures. Leasehold improvements are amortized over the shorter of the lease term or the estimated useful life of the improvements. When property or equipment is retired or otherwise disposed of, the net book value of the asset is removed from the Company's balance sheet and the net gain or loss is included in the determination of income.

Debt Issuance Costs: Costs incurred to issue debt are deferred and amortized as interest expense over the term of the related debt using a method that approximates the effective interest method.

Identifiable Intangibles: Identifiable intangibles include contracts and customer relationships, unpatented technology and non-compete agreements. Effective January 1, 2002, the initial measurement of these intangible assets has been based on their fair values. Fair value for customer relationships and non-compete agreements are derived using the present value of estimated future cash flows, net of income taxes, that are expected to result from the programs. Identifiable intangibles are amortized over their useful lives, which range from 5 to 20 years.

Goodwill: Effective January 1, 2002, the Company accounts for goodwill in accordance with Statement of Financial Accounting Standards (SFAS) No. 142, *Goodwill and other Intangible Assets*. The carrying value of goodwill and indefinite lived identifiable intangible assets are not amortized, but are tested for impairment based on their estimated fair values using discounted cash flows valuation at the beginning of each year, and whenever events or changes in circumstances indicate that the carrying amount of these assets may not be recoverable. Prior to January 1, 2002, goodwill was amortized on a straight-line basis over periods ranging from 15 to 40 years except for goodwill related to acquisitions consummated after June 30, 2001. Prior to the adoption of SFAS No. 142, the Company evaluated the carrying amount of goodwill by reference to current and estimated profitability and undiscounted cash flows.

Income Taxes: The Company provides for income taxes using the liability method. Deferred income tax assets and liabilities reflect tax carryforwards and the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting and income tax purposes, as determined under enacted tax laws and rates.

The effect of changes in tax laws or rates is accounted for in the period of enactment.

Research and Development: Independent research and development costs sponsored by the Company include bid and proposal costs, and relate to both U.S. Government products and services and those for commercial and foreign customers. The independent research and development (IRAD) and bid and proposal costs (B&P) for the Company's businesses that are U.S. Government contractors are allowable indirect contract costs that are allocated to our U.S. Government contracts in accordance with U.S. Government regulations. In accordance with SOP 81-1 and the AICPA Audit and Accounting Guide, *Audits of Federal Government Contractors*, the Company reports IRAD and B&P costs allocated to U.S. Government contracts as costs of sales when the related contract sales are recognized, and are not accounted for as period expenses. Research and development costs for the Company's businesses that are not U.S. Government contractors are expensed as incurred in accordance with SFAS No. 2, *Accounting for Research and Development Costs*.

Customer-funded research and development costs, including software development costs, are incurred pursuant to contracts under which the customer directs the scope of work and are accounted for as direct contract costs, which are not research and development expenses under SFAS No. 2.

Computer Software Costs: The Company's software development costs for computer software to be sold, leased or marketed that are incurred after establishing technological feasibility for the computer software are capitalized as other assets and amortized on a product-by-product basis using the amount that is the greater of the straight-line method over the useful life or the ratio of current revenues to total estimated revenues in accordance with SFAS No. 86, *Accounting for the Costs of Computer Software to Be Sold, Leased or Otherwise Marketed*. Capitalized software development costs, net of accumulated amortization, was \$25,724 at December 31, 2002 and \$16,025 at December 31, 2001, and is included in other assets on the consolidated balance sheets.

Stock Options: The Company accounts for stock options under the recognition and measurement principles of Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees*. Compensation expense for incentive stock options is recognized in income

based on the excess, if any, of L-3 Holdings' fair value of the stock at the grant date of the award or other measurement date over the amount an employee must pay to acquire the stock. When the exercise price for incentive stock options granted to employees equals or exceeds the fair value of the L-3 Holdings common stock at the date of grant, the Company does not recognize compensation expense. The table below presents pro forma net income and EPS had the Company elected to recognize compensation expense in accordance with the fair value approach of SFAS No. 123, *Accounting for Stock-Based Compensation*, as amended by SFAS No. 148, *Accounting for Stock-Based Compensation — Transition and Disclosure — an amendment of SFAS No. 123*.

	Year ended December 31,		
	2002	2001	2000
Net income:			
As reported	\$178,097	\$115,458	\$82,727
Pro forma	160,079	107,573	75,064
Basic EPS:			
As reported	\$ 2.05	\$ 1.54	\$ 1.24
Pro forma	1.84	1.44	1.13
Diluted EPS:			
As reported	\$ 1.93	\$ 1.47	\$ 1.18
Pro forma	1.75	1.38	1.07

The assumptions used to calculate the fair value of stock options at their grant dates are presented in Note 14.

Product Warranties: Product warranty costs are accrued when the covered products are shipped to customers. Product warranty expense is recognized based on the terms of the product warranty and the related estimated costs. Accrued warranty costs are reduced as these costs are incurred.

Use of Estimates: The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of sales and costs and expenses during the reporting period. The most significant of these estimates and assumptions relate to contract estimates of sales and estimated costs to complete contracts in process, estimates of market values for inventories reported

at lower of cost or market, estimates of pension and post-retirement benefit obligations, recoverability of recorded amounts of fixed assets and goodwill, income taxes, litigation and environmental obligations. Actual amounts will differ from these estimates.

Recently Issued Accounting Standards: In August 2001, the FASB issued SFAS No. 143, *Accounting for Asset Retirement Obligations*. SFAS No. 143 applies to legal obligations associated with the retirement of tangible long-lived assets that result from the acquisition, construction, development or normal operation of a long-lived asset, except for certain obligations of lessees. This statement does not apply to obligations that arise solely from a plan to dispose of a long-lived asset. SFAS No. 143 requires that estimated asset retirement costs be measured at their fair values and recognized as assets and depreciated over the useful life of the related asset. Similarly, liabilities for the present value of asset retirement obligations are to be recognized and accreted as interest expense each year to their estimated future value until the asset is retired. These provisions will be applied to existing asset retirement obligations as of the adoption date as a cumulative effect of a change in accounting policy. SFAS No. 143 is effective for the Company's fiscal years beginning January 1, 2003. SFAS No. 143 is not expected to have a material effect on the Company's consolidated results of operations and financial position.

In May 2002, the FASB issued SFAS No. 145, *Rescission of SFAS Nos. 4, 44 and 64, Amendment of SFAS No. 13, and Technical Corrections as of April 2002*. SFAS No. 145, rescinds SFAS No. 4, *Reporting Gains and Losses from Extinguishment of Debt*, and SFAS No. 64, *Extinguishments of Debt Made to Satisfy Sinking-Fund Requirements*. Under the provisions of SFAS No. 145, gains and losses from extinguishment of debt can only be classified as extraordinary items if they meet the criteria in APB Opinion No. 30. The provisions of this Statement related to the rescission of SFAS No. 4 shall be applied in fiscal years beginning after May 15, 2002. Earlier application is permitted. This statement also amends SFAS No. 13, *Accounting for Leases*, to eliminate an inconsistency between the accounting for sale-leaseback transactions and certain lease modifications that have economic effects that are similar, and is effective for transactions occurring after May 15, 2002. This Statement also amends other existing authoritative pronouncements to make various

technical corrections, clarify meanings, or describe their applicability under changed conditions and are effective for financial statements issued on or after May 15, 2002. SFAS No. 145 is not expected to have a material effect on the Company's consolidated results of operations, financial position or cash flows. However, in accordance with the provisions of SFAS No. 145, beginning on January 1, 2003, the loss on the extinguishment of debt of \$16,187 (\$9,858 after-tax) that the Company recorded in June 2002 (see Note 8) will be included in income from continuing operations and not be reported as an extraordinary item.

In July 2002, the FASB issued SFAS No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*. SFAS No. 146 replaces FASBs' Emerging Issues Task Force (EITF) No. 94-3, *Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)*. SFAS No. 146 requires companies to recognize costs associated with exit or disposal activities when they are incurred rather than at the date of a commitment to an exit or disposal plan as was required by EITF No. 94-3. Examples of costs covered by SFAS No. 146 include lease termination costs and certain employee severance costs that are associated with a restructuring, discontinued operation, plant closing, or other exit or disposal activity. SFAS No. 146 is to be applied to exit or disposal activities initiated after December 31, 2002. SFAS No. 146 is not expected to have a material effect on the Company's consolidated results of operations and financial position.

In November 2002, the FASB issued FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others* (FIN 45). This interpretation addresses the disclosures to be made by a guarantor in its interim and annual financial statements about its obligations under guarantees and clarifies when a liability for the obligation undertaken should be recognized. The initial measurement of the liability is the fair value of the guarantee at its inception. This interpretation does not prescribe a specific account for the guarantor's offsetting entry when it recognizes the liability at the inception of a guarantee nor does it specify the subsequent measurement of the guarantors recognized liability. The initial recognition and measurement provisions shall be applied on a prospective basis to guarantees issued or modified after December 31, 2002.

The disclosure requirements are included in Notes 6 and 15. FIN 45 is not expected to have a material effect on the Company's consolidated results of operation and financial position.

In December 2002, the FASB issued SFAS No. 148, *Accounting for Stock-Based Compensation — Transition and Disclosure — an amendment of FASB Statement No. 123*. This Statement amends FASB Statement No. 123, *Accounting for Stock-Based Compensation*, to provide alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. In addition, this Statement amends the disclosure requirements of Statement No. 123 to require prominent disclosures in both annual and interim financial statements about the method of accounting for stock-based employee compensation and the effect of the method used on reported results. The amendments to Statement No. 123 that relate to annual financial statements are effective for the Company's 2002 annual financial statements. The amendments to Statement No. 123 that relate to interim financial statements are effective for the Company's March 31, 2003 financial statements. The Company does not intend to adopt the fair value-based method of accounting for stock-based employee compensation which would require the Company to record a non-cash expense for the estimated fair value of stock-based compensation grants. Instead the Company will continue to apply the disclosure-only provisions of SFAS No. 123 (see accounting policy for stock options above and Note 14). Therefore, SFAS No. 148 is not expected to have a material effect on the Company's consolidated results of operations and financial position.

In January 2003, the FASB issued FASB Interpretation No. 46, *Consolidation of Variable Interest Entities* (FIN 46). This interpretation provides guidance on the identification of, and financial reporting for, entities over which control is achieved through means other than voting rights. Such entities have been termed by FIN 46 as variable interest entities (VIE). Once effective, FIN 46 will be the guidance that determines (1) whether consolidation is required under the "controlling financial interest" model of ARB Bulletin No. 51, *Consolidated Financial Statements*, or (2) whether the variable-interest model under FIN 46 should be used to account for existing and new entities. FIN 46 includes guidance for identifying the enterprise that will consolidate a

VIE, which is the enterprise that is exposed to the majority of an entity's risks or receives the majority of the benefits from an entity's activities. FIN 46 also requires that the enterprises that hold a significant variable interest in a VIE make new disclosures in their financial statements. The transitional disclosures of FIN 46, which are effective immediately, require an enterprise to identify the entities in which it holds a variable interest if the enterprise believes that those entities might be considered VIEs upon the adoption of FIN 46. The implementation and remaining disclosure requirements of FIN 46 are effective immediately for VIEs created after January 31, 2003, and on July 1, 2003 for all VIEs created before January 31, 2003. The Company does not believe that it holds any interests in VIEs, however, the Company is currently evaluating whether it holds a variable interest in entities that might be considered VIEs.

Reclassifications: Certain reclassifications have been made to conform prior-year amounts to the current-year presentation.

3. Aquisitions, Divestiture and Other Transactions

Acquisitions

Aircraft Integration Systems. On March 8, 2002, the Company acquired the assets of Aircraft Integration Systems (AIS), a division of Raytheon Company (Raytheon), for \$1,148,700 in cash, which includes \$1,130,000 for the original contract purchase price, and an increase to the contract purchase price of \$18,700 related to additional net assets received at closing, plus acquisition costs. Following the acquisition, the Company changed AIS's name to L-3 Communications Integrated Systems (IS). The purchase price is subject to adjustment based on the IS closing date net tangible book value, as defined. The acquisition was financed using approximately \$229,000 of cash on hand, borrowings under the Company's senior credit facilities of \$420,000 and a \$500,000 senior subordinated bridge loan (see Note 8). The Company acquired IS because it is a long-standing supplier of critical COMINT, SIGINT and unique sensor systems for special customers within the U.S. Government. The Company believes that IS has excellent operating prospects as its major customers increasingly focus on intelligence gathering and information distribution to the battlefield. The Company also believes there are significant opportunities to apply its proven business integration and cost control skills to further

enhance IS's operating and financial performance. The Company also believes that IS creates significant opportunities for the sale of the Company's secure communications and aviation products, including communication links, signal processing, antennas, data recorders, displays and traffic control and collision avoidance systems.

The table below presents a summary of (1) the initial purchase price allocation for the IS acquired assets and assumed liabilities as was reported in the Company's unaudited condensed consolidated financial statements as of March 31, 2002, (2) the adjustments made to the initial purchase price allocation during the nine months ended December 31, 2002, and (3) the final purchase price allocation

for IS, which includes the results from the audit of AIS's acquired net assets that was performed by the Company's independent auditors and the final appraisals and other valuations of fair value for the IS acquired assets and assumed liabilities. The AIS acquired contracts in process reflected in the Company's initial purchase price allocation for IS was based on the accounting records of AIS, which reflected September 2001 contract estimates prepared by AIS. In order to complete the audit of AIS's acquired net assets and prepare the Company's final purchase price allocation for IS as of March 1, 2002, the effective date of acquisition, the Company updated those September 2001 contract estimates for the five months of activity and changes in circumstances that occurred from September 2001 to March 1, 2002.

	IS Purchase Price Allocation		
	Initial	Adjustment ^(a)	Final
Contracts in process	\$ 360,567	\$(157,245)	\$ 203,322 ^(b)
Other current assets	1,678	81,844	83,522 ^(c)
Property, plant and equipment	182,307	20,408	202,715 ^(d)
Goodwill	663,215	99,155	762,370 ^(e)
Intangible assets	16,894	41,486	58,380 ^(f)
Other non-current assets	37,958	47,710	85,668 ^(c)
Total assets acquired	1,262,619	133,358	1,395,977
Other current liabilities	17,020	100,425	117,445 ^(g)
Pension and postretirement benefits	95,000	24,606	119,606 ^(h)
Other long-term liabilities	1,279	3,334	4,613 ⁽ⁱ⁾
Total liabilities assumed	113,299	128,365	241,664
Net assets acquired	\$1,149,320	\$ 4,993	\$1,154,313

(a) The adjustments to the initial purchase price allocation include the preliminary adjustments recorded by the Company in September 2002 that were reported in the Company's unaudited condensed consolidated financial statements as of September 30, 2002.

(b) The reduction to contracts in process includes \$86,149 to update estimated costs to complete the AIS acquired contracts as of the date of acquisition to reflect changes in circumstances that occurred prior to the date of acquisition; \$74,517 to value acquired contracts in process at estimated contract value less the Company's estimated costs to complete the contracts and a reasonable profit allowance on the Company's completion effort commensurate with the profit margin that the Company earns on similar contracts in accordance with SFAS 141, paragraph 37(c); \$12,000 to reduce the estimated net realizable value of an assumed claim against an AIS subcontractor; \$9,535 to properly translate receivables, inventoried contract costs and estimated billings and costs to complete a foreign contract from Australian dollars to U.S. dollars; \$19,799 primarily to reduce the value of unbilled contract receivables and inventoried contract costs related to inactive and completed contracts for which there is no remaining contract value, to record the results of physical inventory counts and to adjust excess and obsolete inventories for amounts that will not be used on acquired contracts; \$7,816 to reduce the

percentage of completion sales on certain acquired contracts in process in order to reconcile them to AIS's September 2001 contract estimates at completion contained in the accounting records of AIS; and, \$24,856 to record adjustments made by Raytheon prior to the Company's acquisition of AIS which were not reflected in the accounting records of AIS primarily relating to contracts and receivables retained by Raytheon. The AIS acquired contracts in process had an aggregate contract value of approximately \$3,900,000, including funded and unfunded amounts, with approximately \$1,000,000 of funded backlog at the date of acquisition. The majority of the revisions to estimated costs to complete acquired contracts relate to the Sea Sentinel contract, with other amounts relating to the Extract, Peace Pioneer, SIVAM, SRP and LC-130 contracts. The Company's aggregate adjustments to contracts in process discussed in this item (b) amounted to \$234,672. In addition, the Company reclassified \$77,427 of negative balances in contracts in process to other current liabilities (see item (g) below).

- (c) The increases to other current assets and other non-current assets primarily represents estimated deferred income tax assets related to the differences between financial statement amounts and income tax basis amounts included in the final IS acquisition balance sheet and tax purchase price allocations for the acquired assets and assumed liabilities.
- (d) The increase to property, plant and equipment includes a valuation adjustment of \$26,719 to increase the carrying value of land and buildings to fair value based on an independent appraisal, partially offset by a reduction to internal-use software costs and other fixed assets included in the AIS historical net assets that will not be used by the IS business.
- (e) The increase to goodwill represents the effect of the final adjustments to the purchase price allocation. Goodwill in the amount of \$518,412 was assigned to the Secure Communications & ISR segment and \$243,958 was assigned to the Aviation Products & Aircraft Modernization segment. Approximately \$508,350 of the IS goodwill is expected to be deductible for income tax purposes, which is less than the amount of goodwill for financial reporting purposes because of differences in the financial statement amounts and income tax basis amounts for certain of the acquired asset and liabilities, pertaining primarily to contracts in process, property, plant and equipment, other current liabilities and pension and postretirement benefits.
- (f) The increase to intangible assets is to value identifiable intangible assets relating to acquired contracts and customer-relationships and a non-compete agreement based on an independent valuation, reduced by \$16,894 for certain technology rights included in the AIS historical net assets that will not be used by the IS business.
- (g) The increase to other current liabilities is comprised of reclasses of \$77,427 from contracts in process for contracts with credit balances (see item (b) above); \$3,254 for employee termination costs; and \$19,744 for accounts payable, accrued employment costs and accrued expenses assumed in the AIS acquisition that were not recorded in the accounting records of AIS.
- (h) The increase to pension and post retirement benefits is based on the final actuarial valuation for the assumed liabilities.
- (i) The increase to other long-term liabilities represents environmental remediation liabilities assumed in the IS acquisition that were not recorded in the accounting records of AIS.

The final IS purchase price allocation does not include an adjustment for the final purchase price of AIS which will be based on the difference between AIS's final closing date net tangible book value, as defined in the AIS asset purchase agreement, and AIS's net tangible book value as of September 30, 2001. The Company has submitted its proposed purchase price adjustment in accordance with the asset purchase agreement to the Raytheon Company, the seller of the AIS business, which amounts to a reduction of \$100,000 to the final purchase price submitted by Raytheon to the Company. The Company expects to resolve the final purchase price for AIS with the seller in 2003. Any amount received by the Company for a reduction to the AIS purchase price will be recorded as a reduction to the goodwill for IS.

The cash required to fund the revisions that the Company made to the estimated costs to complete the AIS acquired contracts in process and estimated costs in excess of billings on the acquired contracts in a loss position will be reported as reductions to cash flows from operating activities on the Company's statement of cash flows as the costs are incurred.

Detection Systems. On June 14, 2002, the Company completed the acquisition of the detection systems business of PerkinElmer (Detection Systems) for \$110,000 in cash, which includes \$100,000 for the original contract purchase price, and an increase to the contract purchase price of \$10,000 related to a preliminary purchase price adjustment, plus acquisition costs. The purchase price is subject to final adjustment based on closing date net working capital, as defined. Detection Systems offers X-ray screening for several major security applications, including: (1) aviation systems for checked and oversized baggage, break bulk cargo and air freight; (2) port and border applications including pallets, break bulk and air freight; and (3) facility protection such as parcels, mail and cargo. Detection Systems has a broad range of systems and technology, and an installed base of over 16,000 units. Detection Systems' customer base includes major airlines and airports, a number of domestic agencies, such as the U.S. Customs Service, U.S. Marshals Service, U.S. Department of Agriculture and U.S. Department of State, and international authorities throughout Europe, Asia and South America. The acquisition broadens the Company's capabilities and product offerings in the rapidly growing areas of airport security and other homeland defense markets, including explosive detection systems (EDS). The acquisition provides the Company with enhanced manufac-

turing and marketing capabilities, which will be used as the Company works to meet growing demand for its EDS products. Based on the preliminary purchase price allocation for Detection Systems, goodwill of \$59,942 was assigned to the Specialized Products segment and is not expected to be deductible for income tax purposes.

Telos, ComCept and TMA. During the third quarter of 2002, in separate transactions the Company acquired three businesses for an aggregate consideration of \$99,274, which was comprised of \$88,667 in cash, 229,494 shares of L-3 Holdings common stock for part of the ComCept purchase price valued at \$10,607, plus acquisition costs. The purchase prices for ComCept and Technology, Management and Analysis Corporation are subject to adjustment based on the closing date net assets or net working capital of the acquired businesses. The Company acquired:

- all of the outstanding common stock of Telos Corporation (Telos), a business incorporated in California, which provides software development for command, control and communications and other related services for military and national security requirements, on July 19, 2002;
- all of the outstanding common stock of ComCept, Inc. (ComCept), a company with network-centric warfare capabilities, including requirements development, modeling, simulation, communications and systems development and integration for ISR, on July 31, 2002. This acquisition is subject to additional consideration not to exceed 219,088 shares of L-3 Holdings common stock which is contingent upon the financial performance of ComCept for the fiscal years ending June 30, 2003 and 2004; and which will be accounted for as goodwill; and
- all of the outstanding common stock of Technology, Management and Analysis Corporation (TMA), a provider of professional services to the DoD, primarily in support of the Naval surface and combat fleet, on September 23, 2002. The core competencies of TMA include engineering, logistics, ship test and trials, network engineering and support and hardware and software products. This acquisition is subject to additional purchase price not to exceed \$7,000 which is contingent upon the financial performance of TMA for the twelve months ending September 30, 2003 and which will be accounted for as goodwill.

Based on the preliminary purchase price allocations, the goodwill recognized for the acquisitions of Telos, ComCept and TMA was \$87,109, of which \$46,707 is expected to be deductible for income tax purposes. Goodwill of

\$22,421 was assigned to the Secure Communications & ISR segment and \$64,688 was assigned to the Training, Simulation & Support Services segment.

Northrop Grumman's Electron Devices and Displays - Navigation Systems - San Diego Businesses, Wolf Coach, Inc., International Microwave Corporation, Westwood Corporation, Wescam Inc. and Ship Analytics, Inc. During the fourth quarter of 2002, in separate transactions the Company acquired seven businesses for an aggregate purchase price of \$338,766 in cash plus acquisition costs. Except for Westwood Corporation and Wescam Inc., the purchase prices are subject to adjustment based on the closing date net assets or net working capital of the acquired businesses. The Company acquired:

- the net assets of Northrop Grumman's Electron Devices and Displays - Navigation Systems - San Diego businesses on October 25, 2002. Electron Devices is a supplier of microwave power devices to all major prime contractors on key military programs, including missile seekers, aircraft navigation and landing systems, airborne and ground radar's and electronic warfare and communications systems. Following the acquisition, the Company changed Electron Devices' name to L-3 Communications Electron Devices (Electron Devices). Displays - Navigation Systems is a supplier of ruggedized displays and computer and electronic systems for both military and commercial applications. Following the acquisition, the Company changed Displays - Navigation Systems' name to L-3 Communications Ruggedized Command and Control Solutions (Ruggedized C&C);
- all of the outstanding common shares of Wolf Coach, Inc. (Wolf Coach), a producer of mobile communications vehicles, for customers in the television industry, the military and for the homeland defense market, on November 1, 2002. The acquisition is subject to additional purchase price not to exceed \$4,100 which is contingent upon the financial performance of Wolf Coach for the years ending December 31, 2003, 2004 and 2005, and which will be accounted for as goodwill;
- all of the outstanding common stock of International Microwave Corporation (IMC), a global communications company that provides wireless communications, network support services, information technology, defense communications and enhanced surveillance systems, on November 8, 2002. The acquisition is subject to additional purchase price not to exceed \$5,000 which is contingent

upon the financial performance of IMC for the year ending December 31, 2003, and which will be accounted for as goodwill;

- all of the outstanding common stock of Westwood Corporation (Westwood), a supplier of shipboard power control, switchgear and power distribution systems to the United States Navy, Army, Air Force and Coast Guard, on November 13, 2002;
- all of the outstanding common stock of Wescam Inc. (Wescam), a designer and manufacturer of systems for defense applications that capture images from mobile platforms and transmit them in real time to tactical command centers for interpretation and for commercial broadcast applications to production facilities. On November 21, 2002, the Company purchased approximately 78% of the outstanding common shares of Wescam. As of December 23, 2002, the Company had purchased all of the outstanding common shares of Wescam; and
- all of the outstanding common stock of Ship Analytics, Inc (Ship Analytics), a producer of crisis management software, providing command and control for homeland security applications, on December 19, 2002. Ship Analytics also designs, manufactures and operates real-time simulation systems for critical shipboard operations for commercial maritime and naval customers. The acquisition is subject to additional purchase price not to exceed \$13,500 which is contingent upon the financial performance of Ship Analytics for the years ending December 31, 2003, 2004 and 2005, and which will be accounted for as goodwill.

Based on the preliminary purchase price allocations, the goodwill recognized for the acquisitions of Electron Devices, Ruggedized C&C, Wolf Coach, IMC, Westwood, Wescam and Ship Analytics was \$199,038, of which \$41,174 is expected to be deductible for income tax purposes. Goodwill of \$195,575 was assigned to the Specialized Products segment and \$3,463 was assigned to the Training, Simulation & Support Services segment.

Spar Aerospace. At December 31, 2001, the Company had acquired 70.3% of the outstanding common stock of Spar Aerospace Limited (Spar), a leading provider of high-end aviation product modernization, for \$103,172 in cash, plus acquisition costs and acquired control of Spar and the ability to require the remaining stockholders to tender their shares. The Company acquired control of Spar on November 23, 2001 after an initial tender offer under which the Company acquired 65.8% of the outstanding common

stock of Spar. During January 2002, the Company completed the acquisition and paid \$43,641 for the remaining outstanding common stock of Spar which was not tendered to the Company at December 31, 2001.

SY Technology, BT Fuze and Emergent. During the fourth quarter of 2001, in separate transactions the Company acquired three other businesses for an aggregate purchase price of \$149,273 in cash plus acquisition costs, including net purchase price increases of \$10,183 based on the closing date balance sheets of the acquired businesses and \$1,800 of additional purchase price based on the financial performance of the acquired companies for the year ended December 31, 2001. The Company acquired:

- the net assets of SY Technology, Inc. (SY), a provider of air warfare simulation services, on December 31, 2001. This acquisition is subject to additional purchase price not to exceed \$3,000 which is contingent upon the financial performance of SY for the year ended December 31, 2002 and the year ending December 31, 2003 and which will be accounted for as goodwill;
- the net assets of Bulova Technologies, a producer of military fuzes that prevent the inadvertent firing and detonation of weapons during handling, on December 19, 2001. Bulova Technologies was later renamed BT Fuze Products (BT Fuze). This acquisition is subject to additional purchase price not to exceed \$2,500 which is contingent upon the financial performance of BT Fuze for the year ending December 31, 2003 and which will be accounted for as goodwill; and
- all of the outstanding common stock of Emergent Government Services Group (Emergent), a provider of engineering and information services to the U.S. Air Force, Army, Navy and intelligence agencies, on November 30, 2001. Following the acquisition, the Company changed Emergent's name to L-3 Communications Analytics (L-3 Analytics).

Based on the final purchase price allocations, the goodwill recognized in the acquisitions of Spar, SY, BT Fuze and Emergent was \$199,916, of which \$78,497 is expected to be fully deductible for tax purposes. Goodwill of \$103,804 was assigned to the Aviation Products & Aircraft Modernization segment, \$61,075 was assigned to the Training, Simulation & Support Services segment and \$35,037 was assigned to the Specialized Products segment.

KDI and EER. On May 4, 2001, the Company

acquired all of the outstanding common stock of KDI Precision Products (KDI) for \$78,862 in cash plus acquisition costs. On May 31, 2001, the Company acquired all of the outstanding common stock of EER Systems (EER) for \$119,392 in cash plus acquisition costs. The purchase price for EER was increased on December 31, 2002 by \$5,000, which will be paid to the EER shareholders in 2003, for a purchase price adjustment that was based on the financial performance of EER for the year ended December 31, 2002.

TDTs, TrexCom, TCAS, MPRI and Coleman. On February 10, 2000, the Company acquired the assets of the Training Devices and Training Services (TDTs) business of Raytheon Company for \$160,000 in cash plus acquisition costs. Following the acquisition, the Company changed TDTs's name to L-3 Communications Link Simulation and Training (Link Simulation and Training). On February 14, 2000, the Company acquired the assets of the LNR and EMP businesses of Trex Communications Corporation (TrexCom) for \$49,310 in cash plus acquisition costs. On April 28, 2000, the Company acquired the Traffic Alert and Collision Avoidance System (TCAS) product line from Honeywell Inc. for a purchase price of \$239,200 in cash plus acquisition costs. On June 30, 2000, the Company acquired all the outstanding common stock of MPRI Inc. (MPRI) for \$39,606 in cash plus acquisition costs. On December 29, 2000, the Company acquired all of the outstanding common stock of Coleman Research Corporation (Coleman), a subsidiary of Thermo Electron Corporation, for \$60,000 in cash plus acquisition costs, and additional purchase price not to exceed \$5,000 which is contingent upon the financial performance of Coleman for the year ended December 31, 2001.

Additionally, during the years ended December 31, 2002, 2001 and 2000, the Company purchased other businesses, which individually and in the aggregate were not material to its consolidated results of operations, financial position or cash flows in the year acquired.

Substantially all of the acquisitions were initially financed with cash on hand or borrowings on the Company's bank credit facilities.

All of the Company's acquisitions have been accounted for as purchase business combinations and are included in the Company's results of operations from their respective effective dates. The assets and liabilities recorded in connection with the purchase price allocations for the acquisitions of Detection Systems, Telos, ComCept, TMA, Electron Devices and Display – Navigation Systems – San

Diego, Wolf Coach, IMC, Westwood, Wescam and Ship Analytics are based upon preliminary estimates of fair values for contracts in process, inventories, estimated costs in excess of billings to complete contracts in process, identifiable intangibles and deferred income taxes. Actual adjustments will be based on the final purchase prices and final appraisals and other analyses of fair values which are in process. The Company does not expect the differences between the preliminary and final purchase price allocations for the acquisitions to be material. The Company expects to complete the purchase price allocations during the first half of 2003.

Pro Forma Statement of Operations Data. Had the acquisitions of IS, Detection Systems, Telos, ComCept, TMA, Electron Devices, Ruggedized C&C, Wolf Coach, IMC, Westwood, Wescam and Ship Analytics and the related financing transactions occurred on January 1, 2002, the unaudited pro forma sales, net income and diluted earnings per share would have been approximately \$1,353,400, \$76,600 and \$0.76 for the three months ended December 31, 2002, and \$4,699,100, \$167,800 and \$1.71 for the year ended December 31, 2002.

Had the acquisitions of KDI, EER, SY, BT Fuze, L-3 Analytics, Spar, IS, Detection Systems, Telos, ComCept, TMA, Electron Devices, Ruggedized C&C, Wolf Coach, IMC, Westwood, Wescam and Ship Analytics and the related financing transactions occurred on January 1, 2001, the unaudited pro forma sales, net income and diluted earnings per share would have been approximately \$1,157,700, \$20,300 and \$0.22 for the three months ended December 31, 2001, and \$4,139,600, \$113,900 and \$1.21 for the year ended December 31, 2001.

The pro forma results disclosed in the preceding paragraphs are based on various assumptions and are not necessarily indicative of the result of operations that would have occurred had the Company completed the acquisitions and the related financing transactions on January 1, 2001 and January 1, 2002.

Goodrich Avionics Systems. On January 29, 2003, the Company announced that it had agreed to acquire Goodrich Avionics Systems of Goodrich Corporation, for \$188,000 in cash. Goodrich Avionics Systems develops and produces avionics products for commercial and military applications which are focused on aircraft safety and situational awareness, and include collision avoidance systems,

display systems, weather avoidance systems, terrain awareness and warning systems, navigation systems and power supply and conditioning systems. Goodrich Avionics Systems also has a service, repair and overhaul operation. The acquisition is subject to customary closing conditions and is expected to be completed in March 2003.

Divestiture and Other Transactions

On May 31, 2001, the Company sold a 30% interest in Aviation Communications and Surveillance Systems LLC (ACSS) which comprised the Company's TCAS business to Thales Avionics, a wholly owned subsidiary of Thales (formerly Thomson-CSF), for \$75,206 of cash. L-3 continues to consolidate the financial statements of ACSS.

Interest and other income for the year ended December 31, 2001 includes a gain of \$6,966 from the sale of a 30% interest in ACSS which was largely offset by a \$6,341 write-down in the carrying amount of an investment in common stock. Also included in interest and other income for 2001 is a charge of \$515 to account for the increase, in accordance with SFAS No. 133, in the fair value assigned to the embedded derivatives in L-3 Holdings' \$420,000 4% Senior Subordinated Contingent Debt Securities due 2011 sold in the fourth quarter of 2001, and a loss of \$751 from an equity method investment. Interest and other income for the year ended December 31, 2000 includes gains of \$14,940 from the sales of the Company's interests in certain businesses. These gains were largely offset by losses of \$12,456 on the write-down in the carrying value of certain investments and intangible assets. The net proceeds from the sales were \$19,638, and are included in Other Investing Activities on the Statement of Cash Flows. In March 2001, the Company settled certain items with a third party provider related to an existing services agreement. In connection with the settlement, L-3 received a net cash payment of \$14,200. The payment represents a credit for fees being paid over the term of the services agreement and incremental costs incurred by the Company over the same period arising from performance deficiencies under the services agreement. These incremental costs include additional operating costs for material management, vendor replacement, rework, warranty, manufacturing and engineering support, and administrative activities. The \$14,200 cash receipt was recorded as a reduction of costs and expenses in 2001.

4. Contracts in Process

The components of contracts in process are presented in the table below. The unbilled contract receivables, inventoried contract costs and unliquidated progress payments are principally related to contracts with the U.S. Government and prime contractors or subcontractors of the U.S. Government.

	December 31,	
	2002	2001
Billed receivables, less allowances of \$12,801 and \$11,649	\$ 568,382	\$330,795
Unbilled contract receivables	490,678	353,262
Less: unliquidated progress payments	(171,457)	(102,739)
Unbilled contract receivables, net	319,221	250,523
Inventoried contract costs, gross	320,043	122,211
Less: unliquidated progress payments	(13,507)	(6,575)
Inventoried contract costs, net	306,536	115,636
Inventories at lower of cost or market	123,854	104,870
Total contracts in process	\$1,317,993	\$801,824

The Company believes that approximately 93% of the unbilled contract receivables at December 31, 2002 will be billed and collected within one year.

The selling, general and administrative (SG&A) cost data presented in the table below pertains to the Company's businesses that are primarily U.S. Government contractors and have been used in the determination of the Company's costs and expenses for "Contracts, primarily U.S. Government," which are presented on the Company's statements of operations.

	December 31,		
	2002	2001	2000
SG&A costs included in inventoried contract costs at December 31,	\$ 52,253	\$ 19,970	\$ 24,396
SG&A costs included in inventoried contract costs related to businesses acquired during the period	34,417	1,575	3,066
SG&A incurred costs	429,386	298,317	256,470
SG&A included in costs and expenses for Contracts, primarily U.S. Government	431,520	304,318	258,777
Independent research and development, including bid and proposal costs included in SG&A incurred costs	125,108	81,019	77,831

The cost data in the table above does not include the SG&A and research and development expenses for the Company's businesses that are primarily not U.S. Government contractors, which are separately presented on the Company's statement of operations under costs and expenses for "Commercial, primarily products."

5. Goodwill and Other Intangible Assets

Effective January 1, 2002, the Company ceased recording goodwill amortization expense and began testing goodwill for impairment based on estimated fair values at the beginning of the year using a discounted cash flows valuation. Based on the estimated fair values of the Company's reporting units as of January 1, 2002, the goodwill for certain space and broadband commercial communications businesses included in the Specialized Products segment was impaired. In the first quarter of 2002, the Company completed its valuation of the assets and liabilities for these businesses and has recorded an impairment charge of \$24,370, net of a \$6,428 income tax benefit. The impairment charge was recorded as a cumulative effect of a change in accounting principle effective January 1, 2002, in accordance with the adoption provisions of SFAS No. 142.

The table below presents net income and basic and diluted EPS for the year ended December 31, 2002 compared with those amounts for the same period in 2001 and 2000, adjusted to exclude goodwill amortization, net of income taxes for 2001 and 2000.

	Year Ended December 31,		
	2002	2001	2000
Reported income before extraordinary loss and accounting change	\$212,325	\$115,458	\$ 82,727
Add: Goodwill amortization, net of income taxes and minority interest	—	33,899	29,617
Adjusted income before extraordinary loss and accounting change	\$212,325	\$149,357	\$112,344
Adjusted net income	\$178,097	\$149,357	\$112,344
Basic EPS:			
Reported before extraordinary loss and accounting change	\$ 2.44	\$ 1.54	\$ 1.24
Goodwill amortization, net of income tax and minority interest	—	0.45	0.44
Adjusted before extraordinary loss and accounting change	\$ 2.44	\$ 1.99	\$ 1.68
Adjusted net income	\$ 2.05	\$ 1.99	\$ 1.68
Diluted EPS:			
Reported before extraordinary loss and accounting change	\$ 2.29	\$ 1.47	\$ 1.18
Goodwill amortization, net of income tax and minority interest	—	0.40	0.43
Adjusted before extraordinary loss and accounting change	\$ 2.29	\$ 1.87	\$ 1.61
Adjusted net income	\$ 1.93	\$ 1.87	\$ 1.61

The table below presents the changes in goodwill allocated to the reportable segments during the year ended December 31, 2002.

	Secure Comminucations & ISR	Training Simulation & Support Services	Aviation Products & Aircraft Modernization	Specialized Products	Consolidated Total
Balance January 1, 2002	\$181,215	\$377,127	\$371,222	\$ 778,154	\$1,707,718
Acquisitions	540,920	68,300	249,067	259,341	1,117,628
Impairment losses	—	—	—	(30,798)	(30,798)
Balance December 31, 2002	\$722,135	\$445,427	\$620,289	\$1,006,697	\$2,794,548

The gross carrying amount and accumulated amortization balances of the Company's other intangible assets that are subject to amortization are presented in the tables below.

	December 31, 2002		
	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Intangible assets that are subject to amortization:			
Customer relationships	\$80,826	\$ 600	\$80,226
Unpatented technology	9,825	1,844	7,981
Non-compete agreements	2,000	60	1,940
Total	\$92,651	\$2,504	\$90,147

	December 31, 2001		
	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Intangible assets that are subject to amortization:			
Unpatented technology	\$5,000	\$1,167	\$3,833

The Company recorded \$1,337 and \$333 of other intangible asset amortization for the years ended December 31, 2002 and 2001, respectively. Other intangible assets amortization, based on gross carrying amounts at December 31, 2002, is estimated to be \$5,861 for 2003, \$8,580 for 2004, \$9,250 for 2005, \$8,538 for 2006, and \$8,197 for 2007.

6. Other Current Liabilities and Other Liabilities

The components of other current liabilities are presented in the table below.

	December 31,	
	2002	2001
Accrued product warranty	\$ 56,487	\$ 15,968
Negative balances in contracts in process	36,841	—
Estimated cost in excess of billings to complete contracts in process in a loss position	12,451	17,859
Spar purchase price payable	—	43,641
Other	53,114	47,645
Total other current liabilities	\$158,893	\$125,113

The table below presents the changes in the Company's accrual for product warranties for the year ended December 31, 2002.

Balance January 1, 2002	\$15,968
Acquisitions during this period	14,185
Accruals for product warranties issued during the period	34,016
Accruals related to pre-existing product warranties	2,231
Settlements made during the period	(9,913)
Balance December 31, 2002	\$56,487

At December 31, 2002 and 2001, other liabilities include \$13,303 and \$18,814 for the non-current portion of estimated costs in excess of billings to complete contracts in process in a loss position.

7. Property, Plant and Equipment

	December 31,	
	2002	2001
Land	\$ 33,876	\$ 12,947
Buildings and improvements	121,830	38,544
Machinery, equipment, furniture and fixtures	372,602	260,338
Leasehold improvements	121,814	29,232
Gross property, plant and equipment	650,122	341,061
Less: accumulated depreciation and amortization	191,483	137,687
Property, plant and equipment, net	\$458,639	\$203,374

Depreciation expense for property, plant and equipment was \$66,230 for 2002, \$40,362 for 2001 and \$36,158 for 2000.

8. Debt

The components of long-term debt and a reconciliation to the carrying amount of long-term debt are presented in the table below.

	December 31,	
	2002	2001
Borrowings under Senior Credit Facilities	\$ —	\$ —
10 3/8% Senior Subordinated Notes due 2007	—	225,000
8 1/2% Senior Subordinated Notes due 2008	180,000	180,000
8% Senior Subordinated Notes due 2008	200,000	200,000
5 1/4% Convertible Senior Subordinated Notes due 2009	300,000	300,000
4% Senior Subordinated Convertible Contingent Debt Securities due 2011 (CODES)	420,000	420,000
7 5/8% Senior Subordinated Notes due 2012	750,000	—
Principal amount of long-term debt	1,850,000	1,325,000
Less: unamortized discount on CODES	2,248	2,502
Fair value of interest rate swap agreements	—	7,246
Carrying amount of long-term debt	\$1,847,752	\$1,315,252

On February 26, 2002, the Company's lenders approved a \$150,000 increase in the amount of the Senior Credit Facilities. The five-year revolving credit facility, which matures on May 15, 2006, was increased by \$100,000 to \$500,000 and the 364-day revolving credit facility increased by \$50,000 to \$250,000. On February 25, 2003, the maturity date of the \$250,000 364-day revolving credit facility was extended to February 24, 2004.

At December 31, 2002, available borrowings under the Company's Senior Credit Facilities were \$661,405, after reductions for outstanding letters of credit of \$88,595. There were no outstanding borrowings under the Senior Credit Facilities at December 31, 2002.

Borrowings under the Senior Credit Facilities bear interest, at L-3 Communications' option, at either: (i) a "base rate" equal to the higher of 0.50% per annum above the latest federal funds rate and the Bank of America "reference rate" (as defined) plus a spread ranging from 2.00% to 0.50% per annum depending on L-3 Communications' Debt Ratio at the time of determination or (ii) a "LIBOR rate" (as defined) plus a spread ranging from 3.00% to 1.50% per annum depending on L-3 Communications' Debt Ratio at the time of determination. The Debt Ratio is defined as the ratio of Consolidated Total Debt to Consolidated EBITDA. Consolidated Total Debt is equal to outstanding debt plus capitalized lease obligations minus the lesser of actual unrestricted cash or \$50,000. Consolidated EBITDA is equal to

consolidated net income (excluding extraordinary gains and losses, and gains and losses in connection with asset dispositions and discontinued operations) for the most recent four quarters, plus consolidated interest expense, income taxes, depreciation and amortization minus depreciation and amortization related to minority interest. At December 31, 2002, there were no borrowings outstanding under the Senior Credit Facilities. L-3 Communications pays commitment fees calculated on the daily amounts of the available unused commitments under the Senior Credit Facilities at a rate ranging from 0.50% to 0.30% per annum, depending on L-3 Communications' Debt Ratio in effect at the time of determination. L-3 Communications pays letter of credit fees calculated at a rate ranging from 1.50% to 0.75% per annum for performance letters of credit and 3.00% to 1.50% for all other letters of credit, in each case depending on L-3 Communications' Debt Ratio at the time of determination.

In June 2002, L-3 Communications sold \$750,000 of 7 5/8% Senior Subordinated Notes due June 15, 2012 (the "June 2002 Notes") with interest payable semi-annually on June 15 and December 15 of each year commencing December 15, 2002. The net proceeds from this offering and the concurrent sale of common stock by L-3 Holdings (see Note 10) were used to (1) repay \$500,000 borrowed on March 8, 2002, under the Company's senior subordinated bridge loan facility, (2) repay the indebtedness outstanding under the Company's senior credit facilities, (3) repurchase and redeem the 10 3/8% Senior Subordinated Notes due 2007 and (4) increase cash and cash equivalents. The June 2002 Notes are general unsecured obligations of L-3 Communications and are subordinated in right of payment to all existing and future senior debt of L-3 Communications. The June 2002 Notes are subject to redemption at any time, at the option of L-3 Communications, in whole or in part, on or after June 15, 2007 at redemption prices (plus accrued and unpaid interest) starting at 103.813% of the principal amount (plus accrued and unpaid interest) during the 12-month period beginning June 15, 2007 and declining annually to 100% of principal (plus accrued and unpaid interest) on June 15, 2010 and thereafter. Prior to June 15, 2005, L-3 Communications may redeem up to 35% of the June 2002 Notes with the proceeds of certain equity offerings at a redemption price of 107.625% of the principal amount (plus accrued and unpaid interest).

In the fourth quarter of 2001, L-3 Holdings sold \$420,000 of 4% Senior Subordinated Convertible Contingent

Debt Securities (CODES) due September 15, 2011. The net proceeds from this offering amounted to approximately \$407,450 after underwriting discounts and commissions and other offering expenses. Interest is payable semi-annually on March 15 and September 15 of each year commencing March 15, 2002. The CODES are convertible into L-3 Holdings' common stock at a conversion price of \$53.813 per share (7,804,878 shares) under any of the following circumstances: (1) during any Conversion Period (defined below) if the closing sales price of the common stock of L-3 Holdings is more than 120% of the conversion price (\$64.58) for at least 20 trading days in the 30 consecutive trading-day period ending on the first day of the respective Conversion Period; (2) during the five business-day period following any 10 consecutive trading-day period in which the average of the trading prices for the CODES was less than 105% of the conversion value; (3) if the credit ratings assigned to the CODES by either Moody's or Standard & Poor's are below certain specified ratings; (4) if they have been called for redemption by the Company; or (5) upon the occurrence of certain specified corporate transactions. A Conversion Period is the period from and including the thirtieth trading day in a fiscal quarter to, but not including, the thirtieth trading day of the immediately following fiscal quarter. There are four Conversion Periods in each fiscal year. The CODES are subject to redemption at any time at the option of L-3 Holdings, in whole or in part, on or after October 24, 2004 at redemption prices (plus accrued and unpaid interest — including contingent interest) starting at 102% of principal (plus accrued and unpaid interest — including contingent interest) during the 12-month period beginning October 24, 2004 and declining annually to 100% of principal (plus accrued and unpaid interest — including contingent interest) on September 15, 2006. The CODES are general unsecured obligations of L-3 Holdings and are subordinated in right of payment to all existing and future senior debt of L-3.

Additionally, holders of the CODES have a right to receive contingent interest payments, not to exceed a per annum rate of 0.5% of the outstanding principal amount of the CODES, which will be paid on the CODES during any six-month period following a six-month period in which the average trading price of the CODES exceeds 120% of the principal amount of the CODES. The contingent interest payment provision was triggered for the period beginning September 15, 2002 to March 14, 2003 and resulted in additional interest for that period of \$840.

The contingent interest payment provision as well as the ability of the holders of the CODES to exercise the conversion features as a result of changes in the credit ratings assigned to the CODES have been accounted for as embedded derivatives. The initial aggregate fair values assigned to the embedded derivatives was \$2,544, which was also recorded as a discount to the CODES. The carrying values assigned to the embedded derivatives were recorded in other liabilities and are adjusted periodically through other income (expense) for changes in their fair values.

In the fourth quarter of 2000, L-3 Holdings sold \$300,000 of 5 1/4% Convertible Senior Subordinated Notes (Convertible Notes) due June 1, 2009. The net proceeds from this offering amounted to approximately \$290,500 after underwriting discounts and other offering expenses. Interest is payable semi-annually on June 1 and December 1 of each year commencing June 1, 2001. The Convertible Notes may be converted at any time into L-3 Holdings common stock at a conversion price of \$40.75 per share. If all the Convertible Notes were converted, an additional 7,361,964 shares of L-3 Holdings common stock would have been outstanding at December 31, 2002. The Convertible Notes are general unsecured obligations of L-3 Holdings and are subordinated in right of payment to all existing and future senior debt of L-3 Holdings and L-3 Communications. The Convertible Notes are subject to redemption at any time, at the option of L-3 Holdings, in whole or in part, on or after December 1, 2003 at redemption prices (plus accrued and unpaid interest) starting at 102.625% of principal (plus accrued and unpaid interest) during the 12-month period beginning December 1, 2003 and declining annually to 100% of principal (plus accrued and unpaid interest) on December 1, 2005 and thereafter.

In December 1998, L-3 Communications sold \$200,000 of 8% Senior Subordinated Notes due August 1, 2008 (December 1998 Notes) with interest payable semi-annually on February 1 and August 1 of each year commencing February 1, 1999. The December 1998 Notes are general unsecured obligations of L-3 Communications and are subordinated in right of payment to all existing and future senior debt of L-3 Communications. The December 1998 Notes are subject to redemption at any time, at the option of L-3 Communications, in whole or in part, on or after August 1, 2003 at redemption prices (plus accrued and unpaid interest) starting at 104% of principal (plus accrued and unpaid interest) during the 12-month period beginning August 1, 2003

and declining annually to 100% of principal (plus accrued and unpaid interest) on August 1, 2006 and thereafter.

In May 1998, L-3 Communications sold \$180,000 of 8 1/2% Senior Subordinated Notes due May 15, 2008 (May 1998 Notes) with interest payable semi-annually on May 15 and November 15 of each year commencing November 15, 1998. The May 1998 Notes are general unsecured obligations of L-3 Communications and are subordinated in right of payment to all existing and future senior debt of L-3 Communications. The May 1998 Notes are subject to redemption at any time, at the option of L-3 Communications, in whole or in part, on or after May 15, 2003 at redemption prices (plus accrued and unpaid interest) starting at 104.250% of principal (plus accrued and unpaid interest) during the 12-month period beginning May 15, 2003 and declining annually to 100% of principal (plus accrued and unpaid interest) on May 15, 2006 and thereafter.

In April 1997, L-3 Communications sold \$225,000 of 10 3/8% Senior Subordinated Notes due May 1, 2007 (1997 Notes) with interest payable semi-annually on May 1 and November 1 of each year commencing November 1, 1997. On June 6, 2002, L-3 Communications commenced a tender offer to purchase any and all of the \$225,000 aggregate principal amount of 10 3/8% Senior Subordinated Notes due 2007. The tender offer expired on July 3, 2002. On June 25, 2002, L-3 Communications sent a notice of redemption for all of its \$225,000 aggregate principal amount of 10 3/8% Senior Subordinated Notes due 2007 that remained outstanding after the expiration of the tender offer. Upon sending the notice, the remaining notes became due and payable at the redemption price as of July 25, 2002. At December 31, 2002, L-3 Communications had purchased and paid cash for all of these notes plus accrued interest, and premiums, fees and other transaction costs of \$12,469. For the year ended December 31, 2002, L-3 Communications recorded a pre-tax extraordinary loss of \$16,187 (\$9,858 after-tax), comprising premiums, fees and other transaction costs of \$12,469 and \$3,718 to write off the remaining balance of debt issue costs relating to these notes.

Collectively the May 1998 Notes, December 1998 Notes and June 2002 Notes comprise the "Senior Subordinated Notes." The maturities on the Senior Subordinated Notes, Convertible Notes and CODES are \$380,000 in 2008, \$300,000 in 2009, \$420,000 in 2011 and \$750,000 in 2012.

In June and August of 2002, L-3 Communications terminated the interest rate swap agreements entered into in 2001 on \$380,000 of its Senior Subordinated Notes due 2008 and received cash of \$9,302. In connection with the termination, L-3 Communications recorded a reduction in interest expense for the year ended December 31, 2002 of \$4,632, which represented interest reductions related to the period prior to the termination of these swap agreements. The remaining \$4,670 was recorded as a deferred gain and will be amortized as a reduction of interest expense over the remaining terms of the \$380,000 of Senior Subordinated Notes due 2008 at an amount of \$191 per quarter, or \$764 annually. L-3 Communications recorded an additional reduction of interest expense for the year ended December 31, 2002 of \$2,504 relating to interest savings for interest periods which ended prior to the termination of these interest rate swap agreements.

In June 2002, L-3 Communications entered into interest rate swap agreements on \$200,000 of its 7 5/8% Senior Subordinated Notes due 2012. These swap agreements exchanged the fixed interest rate for a variable interest rate on \$200,000 of the \$750,000 principal amount outstanding. On September 30, 2002, L-3 Communications terminated these interest rate swap agreements and received cash of \$13,935 in October 2002. In connection with the termination, L-3 Communications recorded a reduction of interest expense for the year ended December 31, 2002 of \$1,762, which represented interest reductions related to the period prior to the termination of these swap agreements. The remaining \$12,173 was recorded as a deferred gain and will be amortized as a reduction of interest expense over the remaining term of the 7 5/8% Senior Subordinated Notes due 2012 at an amount of \$313 per quarter, or \$1,254 annually.

The Senior Credit Facilities, Senior Subordinated Notes, Convertible Notes and CODES agreements contain financial and other restrictive covenants that limit, among other things, the ability of the Company to borrow additional funds, dispose of assets, or pay cash dividends. The Company's most restrictive covenants are contained in the Senior Credit Facilities, as amended. The covenants require that (1) the Company's Debt Ratio be less than or equal to 4.25 for the quarters ended December 31, 2002 through September 30, 2003, thereafter declining to less than or equal to 3.50 for the quarters ending December 31, 2004 and thereafter, and (2) the Company's Interest Coverage Ratio be greater than or equal to 2.75 for the quarter ended December

31, 2002, and that the minimum allowable Interest Coverage Ratio thereafter increase to greater than or equal to 3.00 for the quarters ending December 31, 2003 and thereafter. The Interest Coverage Ratio is equal to the ratio of Consolidated EBITDA to Consolidated Cash Interest Expense. Consolidated Cash Interest Expense is equal to interest expense less the amortization of deferred debt issue costs included in interest expense. For purposes of calculating the financial covenants under the Senior Credit Facilities, the Convertible Notes and CODES are considered debt of L-3 Communications. The Senior Credit Facilities also limit the payment of dividends by L-3 Communications to L-3 Holdings except for payment of franchise taxes, fees to maintain L-3 Holdings' legal existence, income taxes up to certain amounts, interest accrued on the Convertible Notes and CODES or to provide for operating costs of up to \$1,000 annually. Under the covenant, L-3 Communications may also pay permitted dividends to L-3 Holdings from its excess cash flow, as defined, a cumulative amount of \$5,000, provided that the Debt Ratio is no greater than 3.5 to 1 as of the most recent fiscal quarter. As a result, at December 31, 2002, \$5,000 of L-3 Communications' net assets were available for payment of dividends to L-3 Holdings. Through December 31, 2002, the Company was in compliance with these covenants at all times.

In connection with the Senior Credit Facilities, the Company has granted the lenders a first priority lien on the stock of L-3 Communications and substantially all of its material domestic subsidiaries. The borrowings under the Senior Credit Facilities are guaranteed by L-3 Holdings and by substantially all of the material domestic subsidiaries of L-3 Communications on a senior basis. The payment of principal and premium, if any, and interest on the Senior Subordinated Notes are unconditionally guaranteed, on an unsecured senior subordinated basis, jointly and severally, by substantially all of L-3 Communications' restricted subsidiaries other than its foreign subsidiaries. The guarantees of the Senior Subordinated Notes are junior to the guarantees of the Senior Credit Facilities and rank *pari passu* with each other and the guarantees of the Convertible Notes and the CODES. Additionally, the Convertible Notes and CODES are unconditionally guaranteed, on an unsecured senior subordinated basis, jointly and severally, by L-3 Communications and substantially all of its restricted subsidiaries other than its foreign subsidiaries. These guarantees rank junior to the guarantees of the Senior Credit Facilities and rank *pari passu* with each other and the guarantees of the Senior Subordinated Notes.

9. Financial Instruments

Fair Value of Financial Instruments. The Company's financial instruments consist primarily of cash and cash equivalents, billed receivables, investments, trade accounts payable, customer advances, Senior Credit Facilities, Senior Subordinated Notes, Convertible Notes, CODES, foreign currency forward contracts, interest rate cap and floor contracts, interest rate swap agreements and embedded derivatives related to the issuance of the CODES. The carrying amounts of cash and cash equivalents, billed receivables, trade accounts payable, Senior Credit Facilities, and customer advances are representative of their respective fair values because of the short-term maturities or expected settlement dates of these instruments. The Company's investments are stated at fair value, which is based on quoted market prices, as available, and on historical cost for investments for which it is not practicable to estimate fair value. Adjustments to the fair value of investments, which are classified as available-for-sale, are recorded as an increase or decrease in shareholders' equity and are included as a component of accumulated other comprehensive income. The Senior Subordinated Notes are registered, unlisted public debt which are traded in the over-the-counter market and their fair values are based on quoted trading activity. The fair values of the Convertible Notes and CODES are based on quoted prices for the same or similar issues. The fair value of foreign currency forward contracts were estimated based on exchange rates at December 31, 2002 and 2001. The fair values of the interest rate cap and floor contracts, interest rate swap agreements and the embedded derivatives were estimated by discounting expected cash flows using quoted market interest rates. The carrying amounts and estimated fair values of the Company's financial instruments are presented in the table below.

	December 31,			
	2002		2001	
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
Equity investments accounted for using the cost method	\$ 16,140	\$ 16,140	\$ 13,305	\$ 13,305
Equity investments accounted for using the equity method	8,481	8,481	3,027	3,027
Securities available-for-sale	100	100	100	100
Senior Subordinated Notes	1,130,000	1,170,500	597,754	630,925
Convertible Notes	300,000	385,500	300,000	387,000
CODES	417,752	469,350	417,498	432,600
Interest rate caps	—	—	—	—
Interest rate floor	—	—	(432)	(432)
Foreign currency forward contracts	(454)	(454)	258	258
Interest rate swaps	—	—	(7,246)	(7,246)
Embedded derivatives	(3,087)	(3,087)	(3,060)	(3,060)

Interest Rate Risk Management. To mitigate risks associated with changing interest rates on borrowings under the Senior Credit Facilities, the Company entered into interest rate cap and interest rate floor contracts. The interest rate caps and floors were denominated in U.S. dollars and had designated maturities which occurred every three months until the interest rate cap and floor contracts expired in March 2002. In 2001 and 2002, the Company entered into interest rate swap agreements on certain of its Senior Subordinated Notes to take advantage of the current low interest rate environment. These swap agreements exchanged the fixed interest rate for a variable interest rate on a notional amount equal to either a portion or the entire principal amount of the hedged notes, were denominated in U.S. dollars and had designated maturities which occurred on the interest payment dates of the related Senior Subordinated Notes. Collectively the interest rate cap and floor contracts and interest rate swap agreements are herein referred to as the ("interest rate agreements"). Cash payments received from or paid to the counterparties on the interest rate agreements are the difference between the amount that the reference interest rates are greater than or less than the contract rates on the designated maturity dates, multiplied by the notional amounts underlying the respective interest rate agreements. Cash payments or receipts between the Company and counterparties were recorded as a component of interest expense. The initial cost or receipt of the interest rate cap and floor contracts were deferred and amortized as a component of interest expense over the term of the interest rate cap and floor contracts. The Company manages exposure to counterparty credit risk by entering into the interest rate agreements only with major financial institutions that are expected to fully perform under the terms of such agreements. The notional amounts are used to measure the volume of these agreements and do not represent exposure to credit loss. There were no outstanding interest rate agreements at December 31, 2002.

Foreign Currency Exchange Risk Management. Some of the Company's U.S. operations have contracts with foreign customers which are denominated in foreign currencies. To mitigate the risk associated with certain of these contracts denominated in foreign currency, the Company has entered into foreign currency forward contracts. The Company's activities involving foreign currency forward contracts are designed to hedge the foreign denominated cash paid or received, primarily Euro and British Pound.

The Company manages exposure to counterparty credit risk by entering into foreign currency forward contracts only with major financial institutions that are expected to fully perform under the terms of such contracts. The notional amounts are used to measure the volume of these contracts and do not represent exposure to foreign currency losses.

Information with respect to the interest rate agreements and foreign currency forward contracts is presented in the table below.

	December 31,			
	2002		2001	
	Notional Amount	Unrealized (Losses)	Notional Amount	Unrealized Gains (Losses)
Interest rate swaps	\$ —	\$ —	\$380,000	\$ —
Interest rate caps	—	—	100,000	(107)
Interest rate floor	—	—	50,000	(414)
Foreign currency forward contracts	6,048	(454)	7,138	258

10. Common Stock

On April 23, 2002, the Company announced that its Board of Directors had authorized a two-for-one stock split on all shares of L-3 Holdings' common stock. The stock split entitled all shareholders of record at the close of business on May 6, 2002 to receive one additional share of L-3 Holdings' common stock for every share held on that date. The additional shares were distributed to shareholders in the form of a stock dividend on May 20, 2002. Upon completion of the stock split, L-3 Holdings had approximately 80 million shares of common stock outstanding. All historical share and earnings per share (EPS) data have been restated to give effect to the stock split.

On April 23, 2002, the Company's shareholders approved an increase in the number of authorized shares of L-3 Holdings' common stock from 100,000,000 to 300,000,000 and an increase in the number of authorized shares of L-3 Holdings' preferred stock from 25,000,000 to 50,000,000.

On June 28, 2002, L-3 Holdings sold 14,000,000 shares of its common stock in a public offering for \$56.60 per share. Upon closing, L-3 Holdings received net proceeds after deducting discounts, commissions and estimated expenses of \$766,780. The net proceeds of this offering, which were contributed to L-3 Communications, and the concurrent sale of senior subordinated notes by L-3 Communications (see Note 8) were used to (1) repay \$500,000 borrowed on March

8, 2002, under the Company's senior subordinated bridge loan facility, (2) repay the indebtedness outstanding under the Company's Senior Credit Facilities, (3) repurchase and redeem the 10 3/8% Senior Subordinated Notes due 2007 and (4) increase cash and cash equivalents.

On June 29, 2001, the Company established the L-3 Communications Corporation Employee Stock Purchase Plan (ESPP) and registered 3,000,000 shares of L-3 Holdings' common stock, which may be purchased by employees of L-3 Communications Corporation and its U.S. subsidiaries through payroll deductions. In general, an eligible employee who participates in the ESPP may purchase L-3 Holdings' common stock at a fifteen percent discount. The ESPP is not subject to the Employment Retirement Income Security Act of 1974, as amended. The Company received \$17,478 and \$4,861 of employee contributions for the ESPP in 2002 and 2001, respectively. These contributions were recorded as a component of shareholders' equity in the consolidated balance sheet. During 2002, L-3 Holdings issued 352,054 shares of its common stock to the trustee of the ESPP relating to contributions received during the period July 1, 2001 to June 30, 2002. In January 2003, the Company issued 260,027 shares of L-3 Holdings' common stock to the trustee of the ESPP relating to contributions received during the period July 1, 2002 to December 31, 2002.

On May 2, 2001, L-3 Holdings sold 13,800,000 shares of its common stock in a public offering for \$40.00 per share. L-3 Holdings sold 9,150,000 shares and other selling stockholders, including affiliates of Lehman Brothers Inc., sold 4,650,000 secondary shares. Upon closing, L-3 Holdings received net proceeds after underwriting discounts and commissions and other offering expenses of \$353,622. The net proceeds were contributed to L-3 Communications and were used to repay borrowings under the Senior Credit Facilities, pay for the KDI and EER acquisitions and to increase cash and cash equivalents.

As additional consideration for the ILEX acquisition, L-3 Holdings issued 588,248 shares of its common stock valued at \$17,357 in April 2001 based on the financial performance of ILEX in 1999 and 2000. There is no remaining contingent consideration for the ILEX acquisition.

11. Accumulated Other Comprehensive Loss

The changes in the Company's accumulated other comprehensive balances for each of the three years ended December 31, 2002 are presented in the table below.

	Foreign Currency Translation Adjustments	Unrealized Gains (Losses) on Securities	Unrealized Losses on Hedging Instruments	Minimum Pension Liability Adjustments	Accumulated Other Comprehensive Loss
Balance at January 1, 2000	\$(1,362)	\$ (970)	\$ —	\$ (71)	\$ (2,403)
Period change	(1,222)	(2,728)	—	(819)	(4,769)
Balance at December 31, 2000	(2,584)	(3,698)	—	(890)	(7,172)
Period change	(268)	3,452	(163)	(19,519)	(16,498)
Balance at December 31, 2001	(2,852)	(246)	(163)	(20,409)	(23,670)
Period change	65	—	(114)	(45,580)	(45,629)
Balance at December 31, 2002	\$(2,787)	\$(246)	\$ (277)	\$(65,989)	\$(69,299)

12. Earnings Per Share

A reconciliation of basic and diluted earnings per share (EPS) is presented in the table below.

	Year Ended December 31,		
	2002	2001	2000
Basic:			
Income before extraordinary loss and accounting change	\$212,325	\$115,458	\$82,727
Extraordinary loss, net of income taxes	(9,858)	—	—
Accounting change, net of income taxes	(24,370)	—	—
Net income	\$178,097	\$115,458	\$82,727
Weighted average common shares outstanding	86,943	74,880	66,710
Basic earnings per share before extraordinary loss and accounting change	\$ 2.44	\$ 1.54	\$ 1.24
Basic earnings per share	\$ 2.05	\$ 1.54	\$ 1.24
Diluted:			
Income before extraordinary loss and accounting change	\$212,325	\$115,458	\$82,727
After-tax interest expense savings on the assumed conversion of Convertible Notes	10,316	10,502	—
Income before extraordinary loss and accounting change, including assumed conversion of Convertible Notes	222,641	125,960	82,727
Extraordinary loss, net of income taxes	(9,858)	—	—
Accounting change, net of income taxes	(24,370)	—	—
Net income, including assumed conversion of Convertible Notes	\$188,413	\$125,960	\$82,727
Common and potential common shares:			
Weighted average common shares outstanding	86,943	74,880	66,710
Assumed exercise of stock options	7,750	7,692	7,880
Assumed purchase of common shares for treasury	(4,642)	(4,496)	(4,684)
Assumed conversion of Convertible Notes	7,362	7,362	—
Common and potential common shares	97,413	85,438	69,906
Diluted earnings per share before extraordinary loss and accounting change	\$ 2.29	\$ 1.47	\$ 1.18
Diluted earnings per share	\$ 1.93	\$ 1.47	\$ 1.18

The 7,804,878 shares of L-3 Holdings' common stock that are issuable upon conversion of the CODES were not included in the computation of diluted EPS for the years ended December 31, 2002 and 2001 because the conditions required for the CODES to become convertible have not been met.

13. Income Taxes

Pre-tax income of the Company was \$330,210 for 2002, \$186,222 for 2001 and \$134,079 for 2000, substantially all of which was derived from domestic operations. The components of the Company's provision for income taxes are presented in the table below.

	Year Ended December 31,		
	2002	2001	2000
Current income tax provision, primarily federal	\$ 38,793	\$18,126	\$26,249
Deferred income tax provision:			
Federal	67,524	43,965	23,130
State and local	11,568	8,673	1,973
Subtotal	79,092	52,638	25,103
Total provision for income taxes	\$117,885	\$70,764	\$51,352

A reconciliation of the statutory federal income tax rate to the effective income tax rate of the Company is presented in the table below.

	Year Ended December 31,		
	2002	2001	2000
Statutory federal income tax rate	35.0%	35.0%	35.0%
State and local income taxes, net of federal income tax benefit	3.9	5.3	4.4
Foreign sales corporation and extraterritorial income benefits	(1.8)	(3.6)	(2.6)
Nondeductible goodwill amortization and other expenses	—	4.8	6.8
Research and experimentation and other tax credits	(2.5)	(5.0)	(6.1)
Other, net	1.1	1.5	0.8
Effective income tax rate	35.7%	38.0%	38.3%

The provision for income taxes excludes current tax benefits related to compensation expense deductions for income tax purposes arising from the exercise of stock options that were credited directly to shareholders' equity of \$13,303 for 2002, \$11,939 for 2001, and \$9,108 for 2000. These tax benefits reduced current income taxes payable.

The significant components of the Company's net deferred tax assets and liabilities are presented in the table below.

	December 31,	
	2002	2001
Deferred tax assets:		
Inventoried costs	\$ 43,678	\$ 8,520
Compensation and benefits	15,796	11,460
Pension and postretirement benefits	136,699	59,397
Property, plant and equipment	33,669	16,579
Income recognition on contracts in process	59,663	16,670
Net operating loss carryforwards	6,579	32,480
Tax credit carryforwards	38,385	31,943
Other, net	24,533	21,555
Total deferred tax assets	359,002	198,604
Deferred tax liabilities:		
Goodwill	(49,317)	(26,493)
Other, net	(18,861)	(11,263)
Total deferred tax liabilities	(68,178)	(37,756)
Net deferred tax assets	\$290,824	\$160,848

The following table presents the classification of the Company's net deferred tax assets.

	December 31,	
	2002	2001
Current deferred tax assets	\$143,634	\$ 62,965
Long-term deferred tax assets	147,190	97,883
Total net deferred tax assets	\$290,824	\$160,848

At December 31, 2002, the Company had \$10,596 of federal net operating losses, \$46,474 of state net operating losses and \$38,385 of tax credit carryforwards primarily related to U.S. and state research and experimentation credits and state investment tax credits. The net operating losses, some of which are subject to limitation, expire if unused between 2011 and 2021. The tax credit carryforwards expire, if unused, primarily beginning in 2012. The Company believes that it will generate sufficient taxable income to utilize these net operating losses and tax credit carryforwards before they expire.

14. Stock Options

In April 1999, the Company adopted the 1999 Long Term Performance Plan (1999 Plan). Awards under the 1999 Plan may be granted to any employee or to any other individual who provides services to or on behalf of the Company or any of its subsidiaries, subject to the discretion of the Compensation Committee of the Board of Directors. Awards under the 1999 Plan may be in the form of non-qualified stock options, incentive stock options, stock appreciation rights (SARs), restricted stock and other incentive awards, consistent with the 1999 Plan. In April 1997, the Company

adopted the 1997 Stock Option Plan (1997 Plan). The 1997 Plan authorizes the Compensation Committee of the Board of Directors to grant incentive stock options to key employees of the Company and its subsidiaries. Awards under both plans are in the form of L-3 Holdings' common stock. At December 31, 2002, the number of shares of L-3 Holdings' common stock authorized for grant under the 1999 Plan and 1997 Plan was 16,611,630, of which 2,937,099 shares were available for awards under these plans. The price at which incentive stock options may be granted shall not be less than 100% of the fair market value of L-3 Holdings' common stock on the date of grant. In general, options expire after 10 years and are exercisable ratably over a 3-year period.

At December 31, 2002, the Company has granted restricted stock awards of 282,358 shares, of which 31,838 shares have been forfeited. The Company awarded 54,960 shares on January 1, 2002, 60,928 shares on January 1, 2001 and 85,792 shares on January 1, 2000. The aggregate fair values of the restricted stock awards on their grant dates were \$2,473 in 2002, \$2,346 in 2001 and \$1,713 in 2000. The restricted stock awards granted on January 1, 2002 and January 1, 2001 vest over three years. The restricted stock award granted on January 1, 2000 vests over five years. Compensation expense charged against earnings for these restricted stock awards was \$2,134 in 2002, \$1,370 in 2001 and \$716 in 2000. Shareholders' Equity has been reduced by \$3,302 at December 31, 2002 for unearned compensation on these restricted stock awards.

The table below presents the Company's incentive stock option activity over the past three years under the 1999 Plan and 1997 Plan.

(in thousands)	Number of Options	Weighted Average Exercise Price
Outstanding at January 1, 2000	7,530	\$8.51
Options granted	1,322	23.87
Options exercised	(1,154)	7.76
Options cancelled	(442)	19.91
Outstanding at January 1, 2001 (3,858 exercisable)	7,256	10.71
Options granted	2,214	35.81
Options exercised	(1,128)	14.57
Options cancelled	(362)	21.23
Outstanding at January 1, 2002 (4,216 exercisable)	7,980	16.68
Options granted	2,169	52.02
Options exercised	(970)	17.99
Options cancelled	(155)	35.62
Outstanding at December 31, 2002 (5,216 exercisable)	9,024	\$24.71

The table below summarizes information about the Company's incentive stock options outstanding at December 31, 2002.

Range of Exercise Prices	Outstanding			Exercisable		
	Number of Options	Weighted Average Remaining Contractual Life (Years)	Weighted Average Exercise Price	Number of Options	Weighted Average Remaining Contractual Life (Years)	Weighted Average Exercise Price
\$ 3.24	3,487	4.5	\$ 3.24	3,487	4.5	\$ 3.24
\$11.00	128	5.3	\$11.00	128	5.3	\$11.00
\$16.38 — \$19.84	521	6.7	\$18.80	518	6.7	\$18.80
\$20.25 — \$23.13	516	6.6	\$20.85	362	6.4	\$20.65
\$29.00	283	7.6	\$29.00	151	7.6	\$29.00
\$32.50 — \$35.00	1,121	8.3	\$33.31	293	8.3	\$33.42
\$39.70	837	8.9	\$39.70	277	8.9	\$39.70
\$49.00 — \$53.75	2,131	9.4	\$52.05	—	—	\$ —
Total	9,024	6.9	\$24.71	5,216	5.4	\$10.56

The weighted average fair values of incentive stock options at their grant date during 2002, 2001 and 2000, where the exercise price equaled the market price (estimated fair value) on the grant date were \$18.75, \$14.87 and \$10.10, respectively. In accordance with APB No. 25, no compensation expense was recognized.

For purposes of determining the impact of adopting SFAS No. 123, the estimated fair value of options granted was calculated using the Black-Scholes option-pricing valuation model. The weighted average assumptions used in the valuation models are presented in the table below.

	Year Ended December 31,		
	2002	2001	2000
Expected holding period (in years)	4.0	5.0	5.0
Expected volatility	39.2%	39.5%	35.8%
Expected dividend yield	—	—	—
Risk-free interest rate	4.0%	4.5%	6.4%

15. Commitments and Contingencies

The Company leases certain facilities and equipment under agreements expiring at various dates through 2028. The following table presents future minimum payments under non-cancelable operating leases with initial or remaining terms in excess of one year at December 31, 2002.

	Real Estate	Equipment	Total
2003	\$ 61,572	\$ 9,752	\$ 71,324
2004	56,871	7,759	64,630
2005	74,704	6,012	80,716
2006	41,667	5,490	47,157
2007	36,909	5,133	42,042
Thereafter	197,217	62,050	259,267
Total	\$468,940	\$96,196	\$565,136

Real estate lease commitments have been reduced by minimum sublease rental income of \$1,622 due in the future under non-cancelable subleases. Leases covering major items of real estate and equipment contain renewal and/or purchase options. Rent expense, net of sublease income was \$65,277 for 2002, \$41,370 for 2001 and \$34,123 for 2000.

On December 31, 2002, the Company entered into two real estate lease agreements, as lessee, with an unrelated lessor which expire on December 31, 2005, and which are accounted for as operating leases. On or before the lease expiration date, the Company can exercise options under the lease agreements to either renew the leases, purchase both properties for \$28,000, or sell both properties on behalf of the lessor (the "Sale Option"). If the Company elects the Sale Option, the Company must pay the lessor a residual guarantee amount of \$22,673 for both properties, on or before the lease expiration date, and at the time both properties are sold, the Company must pay the lessor a supplemental rent equal to the gross sales proceeds in excess of the residual guarantee amount not to exceed \$5,327.

For the real estate lease agreements discussed above, if the gross sales proceeds are less than the sum of the residual guarantee amount and the supplemental rent, the Company is required to pay a supplemental rent to the extent the reduction in the fair value of the properties are demonstrated by an independent appraisal to have been caused by the Company's failure to properly maintain the properties. Accordingly, the aggregate residual guarantee amounts of \$22,673 has been included in the non-cancelable real estate operating lease payments relating to the expiration of such leases.

On December 28, 2000, the Company entered into a sale-leaseback transaction on its facility located in Hauppauge, NY. The facility was sold for \$13,650. The lease agreement which is accounted for as an operating lease, has an initial term of 14 years with an annual rent that increases 2.5% annually. The Company has the option to extend the lease term for an additional 3 terms of 5 years each. The gain of \$4,110 on the sale of the facility has been deferred and will be recognized ratably over the term of the lease.

The Company has a contract to provide and operate for the U.S. Air Force (USAF) a full-service training facility, including simulator systems near a USAF base. The Company acted as the construction agent on behalf of the owner-lessors for procurement and construction for the

simulator systems which were completed and delivered in August 2002. On December 31, 2002, the Company, as lessee, entered into an operating lease agreement for a term of 15 years for one of the simulator systems with the owner-lessor. At the end of the lease term, the Company may elect to purchase the simulator system at fair market value, which can be no less than \$2,552 and no greater than \$6,422. If the Company does not elect to purchase the simulator system, then on the date of expiration, the Company shall pay to the lessor, as additional rent \$2,552 and return the simulator system to the lessor. The aggregate non-cancelable rental payments under this operating lease is \$32,480, including the additional rent of \$2,552. On February 27, 2003, the Company, as lessee, entered into an operating lease agreement for a term of 15 years for the remaining simulation systems with the owner-lessor. At the end of the lease term, the Company may elect to purchase the simulator systems at fair market value, which can be no less than \$4,146 and no greater than \$14,544. If the Company does not elect to purchase the simulator systems, then on the date of expiration, the Company shall return the simulator systems to the lessor. The aggregate non-cancelable rental payments under this operating lease is \$53,254.

The Company is engaged in providing products and services under contracts with the U.S. Government and to a lesser degree, under foreign government contracts, some of which are funded by the U.S. Government. All such contracts are subject to extensive legal and regulatory requirements, and, from time to time, agencies of the U.S. Government investigate whether such contracts were and are being conducted in accordance with these requirements. Under U.S. Government procurement regulations, an indictment of the Company by a federal grand jury could result in the Company being suspended for a period of time from eligibility for awards of new government contracts. A conviction could result in debarment from contracting with the federal government for a specified term. Additionally, in the event that U.S. Government expenditures for products and services of the type manufactured and provided by the Company are reduced, and not offset by greater commercial sales or other new programs or products, or acquisitions, there may be a reduction in the volume of contracts or subcontracts awarded to the Company.

In connection with the acquisition on March 8, 2002 of the Aircraft Integration Systems business from Raytheon, the Company assumed responsibility for implementing

certain corrective actions, required under federal law to remediate the Greenville, Texas site location, and to pay a portion of those remediation costs. The hazardous substances requiring remediation have been substantially characterized, and the remediation system has been partially implemented. The Company has estimated that its share of the remediation cost will not exceed \$2.5 million, and will be incurred over a period of 25 years. The Company has established adequate reserves for these costs in the purchase price allocation for this acquisition.

The Company has been periodically subject to litigation, claims or assessments and various contingent liabilities incidental to its business. Management continually assesses the Company's obligations with respect to applicable environmental protection laws. While it is difficult to determine the timing and ultimate cost to be incurred by the Company in order to comply with these laws, based upon available internal and external assessments, with respect to those environmental loss contingencies of which management is aware, the Company believes that even without considering potential insurance recoveries, if any, there are no environmental loss contingencies that, individually or in the aggregate, would be material to the Company's consolidated results of operations. The Company accrues for these contingencies when it is probable that a liability has been incurred and the amount of the loss can be reasonably estimated.

On August 6, 2002, ACSS was sued by Honeywell International Inc. and Honeywell Intellectual Properties, Inc. (collectively, "Honeywell") for alleged infringement of patents that relate to terrain awareness avionics. The lawsuit was filed in the United States District Court for the District of Delaware. In December 2002, Honeywell withdrew without prejudice the lawsuit against ACSS and agreed to proceed with non-binding arbitration. If the matter is not resolved through arbitration, Honeywell may reinstitute the litigation after August 14, 2003. The Company had previously investigated the Honeywell patents and believes that ACSS has valid defenses against Honeywell's patent infringement suit. In addition, ACSS has been indemnified to a certain extent by Thales Avionics, which provided ACSS with the alleged infringing technology. Thales Avionics is the Company's joint venture partner in ACSS. In the opinion of management, the ultimate disposition of Honeywell's pending claim will not result in a material liability to the Company.

On November 18, 2002, the Company initiated a proceeding against OSI Systems, Inc. (OSI) in the United States District Court sitting in the Southern District of New York (the "New York action") seeking, among other things, a declaratory judgment that the Company had fulfilled all of its obligations under a letter of intent with OSI (the "OSI Letter of Intent"). Under the OSI Letter of Intent, the Company was to negotiate definitive agreements with OSI for the sale of certain businesses the Company acquired from PerkinElmer, Inc. on June 14, 2002. On December 23, 2002, OSI responded by filing suit against the Company in the United States District Court sitting in the Central District of California (the "California action") alleging, among other things, that the Company breached its obligations under the OSI Letter of Intent and seeking damages in excess of \$100,000, not including punitive damages. On February 7, 2003, OSI filed an answer and counterclaims in the New York action that asserted substantially the same claims OSI had raised in the California action. The Company has filed a motion to have the California action dismissed in favor of the New York action. Under the OSI Letter of Intent, the Company proposed selling to OSI the conventional detection business and the ARGUS business that the Company recently acquired from PerkinElmer, Inc. Negotiations with OSI lasted for almost one year and ultimately broke down over issues regarding, among other things, intellectual property, product-line definitions, allocation of employees and due diligence. The Company believes that the claims asserted by OSI in its suit are without merit and intends to defend against the OSI claims vigorously.

With respect to those investigative actions, items of litigation, claims or assessments of which it is aware, management of the Company is of the opinion that the probability is remote that, after taking into account certain provisions that have been made with respect to these matters, the ultimate resolution of any such investigative actions, items of litigation, claims or assessments will have a material adverse effect on the consolidated financial position, results of operations or cash flows of the Company.

16. Pensions and Other Employee Benefits

The Company maintains a number of pension plans, both contributory and non-contributory, covering employees at certain locations. Eligibility for participation in these plans varies and benefits are generally based on the participant's compensation and/or years of service. The Company's funding policy

is generally to contribute in accordance with cost accounting standards that affect government contractors, subject to the Internal Revenue Code and regulations thereon. Plan assets are invested primarily in U.S. Government and U.S. Government agency obligations and listed stocks and bonds.

The Company also provides postretirement medical and life insurance benefits for retired employees and dependents at certain locations. Participants are eligible for these benefits when they retire from active service and meet the eligibility requirements for the Company's pension plans. These benefits are funded primarily on a pay-as-you-go basis with the retiree generally paying a portion of the cost through contributions, deductibles and coinsurance provisions.

The following table summarizes the balance sheet impact, as well as the benefit obligations, assets, funded status and rate assumptions associated with the pension and postretirement benefit plans.

	Pensions Plans		Postretirement Benefit Plans	
	2002	2001	2002	2001
Change in Benefit Obligation:				
Benefit obligation at beginning of year	\$ 533,451	\$ 415,483	\$ 87,143	\$ 68,538
Service cost	35,825	18,516	3,777	1,709
Interest cost	43,108	31,428	7,779	4,746
Participants' contributions	260	62	720	607
Amendments	(2,554)	—	(10,032)	—
Actuarial loss	49,990	22,277	4,411	4,043
Acquisitions	77,066	63,793	41,639	12,369
Benefits paid	(23,221)	(18,108)	(6,031)	(4,869)
Benefit obligation at end of year	\$ 713,925	\$ 533,451	\$ 129,406	\$ 87,143
Change in Plan Assets:				
Fair value of plan assets at beginning of year	\$ 430,915	\$ 391,263	\$ —	\$ —
Actual return on plan assets	(27,819)	(13,754)	—	—
Acquisitions	4,250	63,344	—	—
Employer contributions	47,386	8,108	5,311	4,262
Participants' contributions	260	62	720	607
Benefits paid	(23,221)	(18,108)	(6,031)	(4,869)
Fair value of plan assets at end of year	\$ 431,771	\$ 430,915	\$ —	\$ —
Funded status of the plans	\$(282,154)	\$(102,536)	\$(129,406)	\$(87,143)
Unrecognized actuarial loss (gain)	184,894	69,697	(188)	(5,032)
Unrecognized prior service cost	560	3,426	(8,877)	(547)
Net amount recognized	\$ (96,700)	\$ (29,413)	\$(138,471)	\$(92,722)
Amounts Recognized in the Balance Sheets Consist of:				
Accrued benefit liability	\$(205,056)	\$ (62,330)	\$(138,471)	\$(92,722)
Accumulated other comprehensive income	108,356	32,917	—	—
Net amount recognized	\$ (96,700)	\$ (29,413)	\$(138,471)	\$(92,722)
Rate Assumptions:				
Discount rate	6.75%	7.25%	6.75%	7.25%
Rate of return on plan assets	9.00%	9.50%	n.a.	n.a.
Salary increases	4.50%	4.50%	4.50%	4.50%

The annual increase in cost of benefits ("health care cost trend rate") is assumed to be an average of 10.00% in 2002 and is assumed to gradually decrease to a rate of 4.5% thereafter. Assumed health care cost trend rates have a significant effect on amounts reported for post retirement medical benefit plans. A one percentage point decrease in the assumed health care cost trend rates would have the effect of decreasing the aggregate service and interest cost by \$711 and the postretirement medical obligations by \$6,406. A one percentage point increase in the assumed health care cost trend rate would have the effect of increasing the aggregate service and interest cost by \$940 and the postretirement medical obligations by \$7,980.

The following table summarizes the components of net periodic pension and postretirement medical costs.

	Pension Plans			Postretirement Benefit Plans		
	2002	2001	2000	2002	2001	2000
Components of Net Periodic Benefit Cost:						
Service cost	\$ 35,825	\$ 18,516	\$ 16,343	\$ 3,777	\$1,709	\$1,670
Interest cost	43,108	31,428	28,029	7,779	4,746	4,754
Amortization of prior service cost	312	351	351	(1,701)	(99)	(99)
Expected return on plan assets	(40,663)	(37,716)	(39,109)	—	—	—
Recognized actuarial (gain) loss	3,246	(424)	(3,981)	(530)	(887)	(865)
Recognition due to settlement	62	—	307	—	—	—
Net periodic benefit cost	\$ 41,890	\$ 12,155	\$ 1,940	\$9,325	\$5,469	\$5,460

The accumulated benefit obligation, projected benefit obligation, and fair value of plan assets for pension plans with accumulated benefit obligations in excess of plan assets were \$565,904, \$696,968 and \$406,809, respectively, as of December 31, 2002 and \$300,072, \$324,840 and \$247,383, respectively, as of December 31, 2001.

In connection with the Company's acquisition in 1997 of the ten business units from Lockheed Martin and the formation of the Company, the Company assumed certain defined benefit plan liabilities for present and former employees and retirees of certain businesses which we acquired from Lockheed. Lockheed Martin also has provided the Pension Benefit Guaranty Corporation ("PBGC") with commitments to assume sponsorship or other forms of financial support under certain circumstances with respect to the Company's pension plans for Communication Systems – West and Aviation Recorders (the "Subject Plans"). Upon the occurrence of certain events, Lockheed Martin, at its option, has the right to decide whether to cause the Company to transfer sponsorship of any or all of the Subject Plans to Lockheed Martin, even if the PBGC has not sought to terminate the Subject Plans. Such a triggering event occurred in 1998, but reversed in 1999, relating to a decrease in the PBGC-mandated discount rate in 1998 that had resulted in an increase in the underlying liability. The Company notified Lockheed Martin of the 1998 triggering event, and in February 1999, Lockheed Martin informed the Company that it had no present intention to exercise its right to cause the Company to transfer sponsorship of the Subject Plans. If Lockheed Martin did assume sponsorship of these plans, it would be primarily liable for the costs associated with funding the Subject Plans or any costs associated with the termination of the Subject Plans but L-3

Communications would be required to reimburse Lockheed Martin for these costs. To date, the impact on pension expense and funding requirements resulting from this arrangement has not been significant. However, should Lockheed Martin assume sponsorship of the Subject Plans or if these plans were terminated, the impact of any increased pension expenses or funding requirements could be material to the Company. For the year ended December 31, 2002, the Company contributed \$18,753 to the Subject Plans. The Company has performed its obligations under the letter agreement with Lockheed Martin and the Lockheed Martin Commitment and has not received any communications from the PBGC concerning actions which the PBGC contemplates taking in respect of the Subject Plans.

Employee Savings Plans. Under its various employee savings plans, the Company matches the contributions of participating employees up to a designated level. The extent of the match, vesting terms and the form of the matching contributions vary among the plans. Under these plans, the Company's matching contributions in L-3 Holdings' common stock and cash were \$36,120 for 2002, \$21,462 for 2001 and \$15,201 for 2000.

17. Supplemental Cash Flow Information

	Year Ended December 31,		
	2002	2001	2000
Interest paid	\$109,301	\$81,552	\$81,390
Income tax payments, net of refunds	2,127	4,904	10,052
Noncash transactions:			
Common stock issued related to acquisition	10,607	17,357	—
Contribution in common stock to savings plans	28,138	16,868	12,642

18. Segment Information

The Company has four reportable segments: (1) Secure Communications & ISR, (2) Training, Simulation & Support Services, (3) Aviation Products & Aircraft Modernization and (4) Specialized Products, which are described in Note 1. The Company evaluates the performance of its operating segments and reportable segments based on their sales and operating income. All corporate expenses are allocated to the Company's divisions using an allocation methodology prescribed by U.S. Government regulations for government contractors. Accordingly, all costs and expenses are included in the Company's measure of segment profitability.

	Secure Communications & ISR	Training, Simulation & Support Services	Aviation Products & Aircraft Modernization	Specialized Products	Corporate	Elimination of Intersegment Sales	Consolidated Total
2002							
Sales	\$998,843	\$826,286	\$733,300	\$1,479,996	\$ —	\$(27,196)	\$4,011,229
Operating income	104,054	96,513	105,075	148,337			453,979
Total assets	1,149,016	648,554	965,038	1,940,982	538,718		5,242,308
Capital expenditures	19,350	4,957	14,035	23,542	174		62,058
Depreciation and amortization	23,692	6,857	15,513	29,798			75,860
2001							
Sales	\$452,152	\$597,029	\$263,450	\$1,040,753	\$ —	\$(5,962)	\$2,347,422
Operating income	31,975	65,715	85,602	92,038			275,330
Total assets	366,482	497,368	545,517	1,382,010	547,872		3,339,249
Capital expenditures	11,561	2,999	9,625	23,657	279		48,121
Depreciation and amortization	13,839	13,207	12,064	47,841			86,951
2000							
Sales	\$405,379	\$283,407	\$209,207	\$1,028,802	\$ —	\$(16,734)	\$1,910,061
Operating income	54,174	23,491	66,854	78,199			222,718
Total assets	293,023	295,139	360,469	1,325,108	189,805		2,463,544
Capital expenditures	6,405	2,762	2,145	21,667	601		33,580
Depreciation and amortization	13,093	6,401	10,085	44,675			74,254

Corporate assets not allocated to the reportable segments primarily include cash and cash equivalents, corporate office fixed assets, deferred income tax assets and deferred debt issuance costs.

Substantially all of the Company's operations are domestic. The Company's foreign operations are not material to the Company's results of operations, cash flows or financial position. Sales to principal customers are summarized in the table below.

	Year Ended December 31,		
	2002	2001	2000
U.S. Government agencies	\$3,107,271	\$1,614,858	\$1,284,379
Foreign governments	395,062	200,913	144,274
Commercial export	179,948	218,971	172,101
Other (principally U.S. commercial)	328,948	312,680	309,307
Consolidated sales	\$4,011,229	\$2,347,422	\$1,910,061

The Company's sales by product and services are summarized in the table below.

	Year Ended December 31,		
	2002	2001	2000
Aircraft modification and maintenance	\$ 517,309	\$ 15,067	\$ —
Security and detection systems	431,325	18,058	13,624
Intelligence, surveillance and reconnaissance products	410,412	—	—
Military and high data rate communications	306,650	231,895	230,478
Ocean products	280,564	299,684	342,861
Telemetry and instrumentation	243,420	254,664	295,266
Avionics products	229,734	254,983	219,307
Information security systems	201,934	140,153	95,342
Training devices and motion simulators	144,310	160,549	148,394
Fuzing products	142,135	62,973	—
Navigation products	141,778	128,690	133,821
Space and commercial communications, satellite control and tactical sensor systems	106,084	88,225	85,247
Microwave components	93,365	112,896	92,767
Subtotal products	3,249,020	1,767,837	1,657,107
Simulation and support services	569,351	378,186	123,742
Training services	256,935	218,843	159,665
Subtotal services	826,286	597,029	283,407
Intercompany eliminations	(64,077)	(17,444)	(30,453)
Total	\$4,011,229	\$2,347,422	\$1,910,061

19. Unaudited Quarterly Financial Data

Unaudited summarized financial data by quarter for the years ended December 31, 2002 and 2001 is presented in the table below.

	March 31	June 30	September 30	December 31
2002				
Sales	\$696,840	\$955,189	\$1,053,613	\$1,305,587
Operating income	\$ 71,307	\$ 97,688	\$ 127,387	\$ 157,597
Income before extraordinary loss and cumulative effect of a change in accounting principle	\$ 29,279	\$ 41,498	\$ 61,760	\$ 79,788
Extraordinary loss on early extinguishment of debt, net of income taxes	—	(9,858)	—	—
Cumulative effect of a change in accounting principle, net of income taxes	(24,370)	—	—	—
Net income	\$ 4,909	\$ 31,640	\$ 61,760	\$ 79,788
Basic EPS:				
Income before extraordinary loss and accounting change	\$ 0.37	\$ 0.52	\$ 0.66	\$ 0.84
Extraordinary loss	—	(0.12)	—	—
Cumulative effect of a change in accounting principle	(0.31)	—	—	—
Net income	\$ 0.06	\$ 0.40	\$ 0.66	\$ 0.84
Diluted EPS:				
Income before extraordinary loss and accounting change	\$ 0.36	\$ 0.49	\$ 0.62	\$ 0.79
Extraordinary loss	—	(0.11)	—	—
Cumulative effect of a change in accounting principle	(0.30)	—	—	—
Net income	\$ 0.06	\$ 0.38	\$ 0.62	\$ 0.79
2001				
Sales	\$461,901	\$561,560	\$ 618,164	\$ 705,797
Operating income	46,869	60,467	75,208	92,786
Net income	14,158	23,336	33,435	44,529
Basic EPS	\$ 0.21	\$ 0.31	\$ 0.43	\$ 0.57
Diluted EPS	\$ 0.20	\$ 0.30	\$ 0.41	\$ 0.53

Report of Independent Auditors

To the Board of Directors and Shareholders of L-3 Communications Holdings, Inc.

We have audited the accompanying consolidated balance sheets of L-3 Communications Holdings, Inc. and subsidiaries (the "Company") as of December 31, 2002 and 2001, and the related consolidated statements of operations, changes in shareholders' equity and cash flows for each of the three years ended December 31, 2002. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatements. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We

believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of the Company and subsidiaries as of December 31, 2002 and 2001 and their consolidated results of operations and cash flows for each of the three years ended December 31, 2002, in conformity with accounting principles generally accepted in the United States of America.

As indicated in Note 5 to the financial statements, in 2002 the Company adopted the provisions of Statement of Financial Accounting Standards No. 142, *Goodwill and Other Intangible Assets*.



1177 Avenue of the Americas
New York, New York
January 27, 2003

Report of Management

The consolidated financial statements and other financial data contained in this annual report have been prepared in conformity with generally accepted accounting principles in the United States of America. The integrity and objectivity of this financial information is the responsibility of management. To this end, management maintains an adequate system of internal controls and supports an extensive program of internal reviews and audits to provide reasonable assurance that the Company's assets are protected and that transactions and events are recorded properly.

The consolidated financial statements have been audited by PricewaterhouseCoopers LLP, Independent Auditors. The Report of Independent Auditors, above, expresses an informed judgment as to whether management's financial statements, considered in their entirety, present fairly, in conformity with generally accepted accounting principles in the United States of America, the Company's financial position, results of operations and cash flows. This judgment is based on procedures described in the second paragraph of their report. These procedures include an assessment of the Company's internal control structure, and performing tests and other auditing procedures sufficient to provide reasonable assurance that the financial statements are free of material misstatements.

To further assure objectivity, the financial information contained in this annual report is subject to review by the Audit Committee of the Board of Directors. The Audit Committee, composed of outside directors who are not employees, meets periodically with management, the internal auditors and the independent auditors to discuss auditing, internal control and financial reporting matters. The internal auditors and independent auditors periodically meet alone with the Audit Committee and have unlimited access to the Audit Committee at any time.

We believe that our policies and procedures provide reasonable assurance that operations are conducted in conformity with applicable laws and with our commitment to a high standard of business conduct.



Robert V. LaPenta
President and
Chief Financial Officer



Michael T. Strianese
Senior Vice President—
Finance

L-3 Communications Officers

Frank C. Lanza Chairman and Chief Executive Officer

Robert V. LaPenta President and Chief Financial Officer

Christopher C. Cambria Senior Vice President,
Secretary and General Counsel

Charles J. Schafer Senior Vice President of Business
Operations and President of Products Group

Michael T. Strianese Senior Vice President of Finance

General Jimmie V. Adams (USAF – Retired)
Vice President of Washington Operations

David T. Butler III Vice President of Planning

Ralph G. D'Ambrosio Vice President and Controller

Kenneth W. Manne Vice President of Human Resources

Joseph S. Paresi Vice President of Product
Development and President of Security and Detection
Systems Division

David M. Reilly Vice President, Assistant General
Counsel and Assistant Secretary

General Robert W. RisCassi (US Army – Retired)
Vice President of Washington Operations

Stephen M. Souza Vice President and Treasurer

Cynthia A. Swain Vice President of Corporate
Communications

Jill J. Wittels, Ph.D. Vice President of Business
Development

Curtis Brunson Corporate Vice President and
President of Communication Systems-West Division

Anthony Caputo Corporate Vice President and
President of L-3 Communications Canada

Robert W. Drewes Corporate Vice President and
President of L-3 Integrated Systems

Alan R. Dietrich Corporate Vice President and
President of Telemetry Group

Steve Kantor Corporate Vice President
and President of SPD Technologies Group

John S. Mega Corporate Vice President and
President of Microwave Group

Gregory B. Roberts Corporate Vice President
and President of Communication Systems-East Division

Shareholder Information

Corporate Headquarters

You can contact corporate headquarters by writing to:
L-3 Communications, 600 Third Avenue, New York, NY 10016,
or by calling 212-697-1111. To send a fax, dial 212-867-5249.

Corporate Information

News media, analysts, shareholders and others seeking
corporate information about L-3 Communications should
contact Cynthia Swain, vice president of corporate
communications at 212-697-1111.

Printed Materials

Printed financial materials, including the 2002 Annual Report,
may be obtained without charge from L-3's Investor Relations
firm, Morgen-Walke Associates, by calling 212-850-5600.

Internet

You can access quarterly and annual financial information,
news releases and an overview of the company's
products and services through the L-3 web site at
<http://www.L-3com.com> on the Internet.

Auditors

PricewaterhouseCoopers LLP, New York, NY.

Shareholder Assistance

If you have questions concerning your shareholder account,
please contact the stock transfer agent, EquiServe, P.O. Box
43069, Providence, RI 02940-3069, or call 800-519-3111.
For the hearing impaired, the phone number is
TDD: 781-575-2692.

You can also contact the stock transfer agent at their web site
at <http://www.equiserve.com> on the Internet.

Stock Exchange Listing

The common stock of L-3 Communications is traded on the
New York Stock Exchange under the symbol LLL.

Annual Meeting

The annual meeting of shareholders will be held at 2:30 p.m.
on Tuesday, April 22, 2003 at the Rihga Royal New York
Hotel, 151 West 54th Street, New York, NY.

Equal Opportunity Employer

L-3 Communications Corporation is an equal opportunity
employer. All matters regarding recruiting, hiring, training,
compensation, benefits, promotions, transfers and all other
personnel policies will continue to be free from discriminato-
ry practices.



communications

**600 Third Avenue
New York, NY 10016**