APPLIED SIGNAL TECHNOLOGY INC
Form 10-Q
June 09, 2004

United States
Securities and Exchange Commission
Washington, D.C. 20549

Form 10-Q

(Mark One)

[X] Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the Period Ended April 30, 2004

or

[ ] Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the Transition Period from ____________________to ____________________.

Commission file number 0-21236

Applied Signal Technology, Inc.

(Exact name of registrant as specified in its charter)

California	77-0015491
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

400 West California Avenue, Sunnyvale, CA 94086

(408) 749-1888

(Registrant s telephone number, including area code)

Not Applicable

(Former name, former address, and former fiscal year, if changed since last report)

Indicate by a check whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter periods that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

ü		
Yes		No

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

ü		
Yes		No

Applicable Only to Corporate Issuers

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practical date.

Common Stock, no par value, 11,011,295 shares outstanding as of April 30, 2004.

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Applied Signal Technology, Inc.

Part I. Financial Information

Item 1: Condensed Financial Statements

Applied Signal Technology, Inc.
Balance Sheets
(In thousands, except share data)

Assets	**April 30, 2004 (Unaudited)**	October 31, 2003 (Note)
Current assets:		
Cash and cash equivalents	$26,881	$5,372
Short term investments	21,139	34,747
Accounts receivable:		
Billed	19,206	16,335
Unbilled	11,601	10,227
Total accounts receivable	30,807	26,562
Inventory	5,869	6,875
Prepaid and other current assets	3,606	3,545
Total current assets	88,302	77,101
Property and equipment, at cost:		
Machinery and equipment	45,810	44,127
Furniture and fixtures	4,798	4,742
Leasehold improvements	10,243	10,236
Construction in process	44	33
	60,895	59,138
Accumulated depreciation and amortization	(48,961)	(46,897)
Net property and equipment	11,934	12,241
Other assets	1,950	605

Total assets	$102,186	$89,947
	=======	=======

Applied Signal Technology, Inc.
Balance Sheets (continued)
(In thousands, except share data)

Liabilities and Shareholders Equity	**April 30, 2004 (Unaudited)**	October 31, 2003 (Note)
Current liabilities:		
Accounts payable	$5,000	$3,022
Accrued payroll and related benefits	8,566	7,557
Accrued rent	1,169	1,190
Other accrued liabilities	2,271	1,643
Income taxes payable	2,715	134
Total current liabilities	19,721	13,546
Other liabilities	275	183
Shareholders equity:		
Common stock, no par value: 20,000,000 shares authorized; issued and outstanding: 11,011,295 at April 30, 2004 and 10,767,145 at October 31, 2003	33,829	31,132
Retained earnings	48,367	45,021
Accumulated comprehensive income	(6)	65
Total shareholders equity	82,190	76,218
Total liabilities and shareholders equity	$102,186	$89,947
	========	========

Note: The balance sheet at October 31, 2003 has been derived from the audited financial statements at that date but does not include all of the information required by accounting principles generally accepted in the United States for complete financial statements.

See Notes to Condensed Financial Statements.

Applied Signal Technology, Inc.
Statements of Operations
(Unaudited)
(In thousands, except per share data)

	Three Months Ended		Six Months Ended	
	April 30, 2004	May 2, 2003	April 30, 2004	May 2, 2003
Revenues from contracts	$ 36,811	$ 22,081	$ 65,105	$ 40,259
Operating expenses:				
Contract costs	24,146	13,856	42,446	25,412
Research and development	3,419	1,900	5,556	3,601
General and administrative	4,534	3,805	9,215	6,726
Total operating expenses	32,099	19,561	57,217	35,739
Operating income	4,712	2,520	7,888	4,520
Interest income, net	137	100	278	200
Income before provision for income taxes	4,849	2,620	8,166	4,720
Provision for income taxes	912	393	2,073	708
Net income	$ 3,937	$ 2,227	$ 6,093	$ 4,012
Net income per common share:				
Basic	$ 0.36	$ 0.22	$ 0.56	$ 0.39
Diluted	$ 0.34	$ 0.21	$ 0.53	$ 0.38
Number of shares used in calculating net income per common share:				
Basic	10,990	10,062	10,922	10,262
Diluted	11,565	10,400	11,500	10,527

See Notes to Condensed Financial Statements.

Applied Signal Technology, Inc.
Statements of Cash Flows
Increase (decrease) in cash and cash equivalents
(Unaudited)
(In thousands)

	Six Months Ended	
	April 30, 2004	May 2, 2003
Operating Activities:		
Net income	$6,093	$4,012
Adjustments to reconcile net income to net cash provided by operating activities		
Depreciation and amortization	2,210	2,374
Changes in:		
Accounts receivable	(4,245)	4,033
Inventory, prepaids, and other assets	(400)	(3,012)
Accounts payable, taxes payable, and accrued expenses	5,564	868
Net cash provided by operating activities	9,222	8,275
Investing Activities:		
Purchases of available-for-sale securities	(24,781)	(14,603)
Maturities of available-for-sale securities	38,317	2,483
Additions to property and equipment	(1,903)	(1,305)
Net cash provided by (used in) investing activities	11,633	(13,425)
Financing Activities:		
Issuance of common stock	2,698	1,263
Dividends paid		

	(2,044)	
Net cash provided by financing activities	654	1,263
Net increase (decrease) in cash and cash equivalents	21,509	(3,887)
Cash and cash equivalents, beginning of period	5,372	11,715
Cash and cash equivalents, end of period	$26,881	$7,828
Supplemental disclosures of cash flow information:		
Interest paid	$75	$64
Income taxes paid	$359	$952

See Notes to Condensed Financial Statements.

Applied Signal Technology, Inc.
Notes to Condensed Financial Statements
(unaudited)
April 30, 2004

Note 1: Summary of Significant Accounting Policies

Description of Business and Basis of Presentation

Applied Signal Technology, Inc. was incorporated in California on January 12, 1984. We provide advanced digital signal processing products, systems, and services used in reconnaissance of telecommunications signals for intelligence gathering, a process referred to as signal intelligence. Our primary customer is the United States Government. Substantially all of our revenues were from contracts with the United States Government, its agencies, or prime contractors for the United States Government.

The accompanying unaudited condensed financial statements have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements, and should be read in conjunction with the financial statements and footnotes thereto included in our Annual Report on Form 10-K for the year ended October 31, 2003. In the opinion of management, all adjustments (consisting of normal recurring adjustments) considered necessary for a fair presentation have been included. Operating results for the three-month and six-month periods ending April 30, 2004 are not necessarily indicative of the results that may be expected for the year ending October 31, 2004.

Estimates

In order for us to prepare financial statements in conformity with accounting principles generally accepted in the United States, management is required to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ significantly from those estimates.

Revenues and Contract Accounting

Revenues and cost recognition. The majority of our contracts are accounted for in accordance with the American Institute of Certified Public Accountants Statement of Opinion 81-1, *Accounting for Performance of Construction-Type and Production-Type Contracts.* These contracts are executed using written contractual arrangements, most of which require us to design, develop, manufacture and/or modify our complex products, and perform related services according to specifications provided by the customer.

We account for cost-reimbursement contracts by charging actual labor, materials, and other direct costs, plus estimated indirect costs of operations as incurred. Indirect costs include overhead, research and development, and general and administrative expenses. General and administrative costs are not applied to certain subcontract costs associated with our cost-reimbursable contracts. These subcontracts must be in excess of $250,000 and must meet certain other predetermined criteria.

We recognize contract revenues and profits on cost-reimbursement contracts by applying an estimated fee rate to all costs incurred on an individual contract basis. Fee calculations are based on either negotiated fee amounts or management s assessment of the fee amounts that are likely to be earned.

Our policy for recognizing interim award fees on our cost-plus-award-fee contracts is based on management s assessment as to the likelihood that the award fee or an incremental portion thereof will be earned, on a contract-by-contract basis. Management s assessments are based on numerous factors including: contract terms, nature of the work to be performed, our relationship and history with the customer, our history with similar types of projects, and our current and anticipated performance on the specific contract. No award fee is recognized in whole or in part until management determines that it is probable that the award fee or portion thereof will be earned. If management s assessment is incorrect, the adjustment to profits resulting from such revisions may affect future period earnings.

Our engineering services contracts are typically performed on a level-of-effort basis. Revenue is recognized in accordance with our policy regarding cost-reimbursement contracts.

We account for fixed-price contracts by using the percentage-of-completion method of accounting. Under this method, labor, materials, and other direct costs, plus estimated indirect costs of operations are charged as incurred. A portion of the contract revenue, based on estimated profits and the degree of completion of the contract as measured by a comparison of the actual and estimated costs, is recognized as revenue each period. Unexpected increases in the cost to develop or manufacture a product under a fixed-price contract, whether due to inaccurate estimates in the bidding process, unanticipated increases in material costs, inefficiencies, or other factors, are borne by us, and could have a material, adverse effect on our results of operations.

The following table represents the revenue concentration by contract type:

	Three Months Ended		Six Months Ended	
	April 30, 2004	May 2, 2003	April 30, 2004	May 2, 2003
Cost-reimbursement contracts	76%	77%	75%	75%
Fixed-price contracts	24%	23%	25%	25%

For those contracts in which all of the terms have not yet been finalized, revenue does not include an estimated fee rate on cost.

Management reviews contract performance, costs incurred, and estimated completion costs regularly. Revenues and profits are adjusted on all contracts in the period in which changes, including anticipated losses, become determinable.

Revenues from our software licenses are accounted for under AICPA Statement of Position 97-2, *Software Recognition*. Revenues from our software licenses have been insignificant in all periods presented.

Indirect rate variance adjustments to operations. We record contract revenues and costs of operations for interim reporting purposes based on annual targeted indirect rates. At year-end, the revenues and costs are adjusted for actual indirect rates. During our interim reporting periods, variances may accumulate between the actual indirect rates and the annual targeted rates. All timing-related indirect spending variances are removed from contract costs, research and development, and general and administrative expenses, and are included in inventory as part of work in process during these interim reporting periods. These rates are reviewed regularly, and we record reserves for any material, permanent variances in the period they become determinable.

Our accounting policy for recording indirect rate variances is based on management s belief that variances accumulated during interim reporting periods will be absorbed by expected contract activities during the remainder of the year. We consider the rate variance to be unfavorable when our actual indirect rates are greater than our annual targeted rates. In contrast, a favorable rate variance occurs when our actual indirect rates are lower than our annual targeted rates. During interim reporting periods, unfavorable rate variances are recorded as reductions to operating expenses and increases to work in process inventory. Favorable rate variances are recorded as increases to operating expenses and decreases to work in process inventory. Please refer to "Notes to Condensed Financial Statements, Note 2: Inventory" for the current year inventoried indirect rate variance.

If we anticipate that actual contract activities will be different than planned levels, there are alternatives we can utilize to absorb the variance: we can adjust our planned indirect spending during the year, modify our billing rates to our customers, or record adjustments to expense based on estimates of future contract activities.

If our rate variance is unfavorable, the modification of our billing rates will likely increase revenue and operating expenses, and decrease inventory. Fee percentages on fixed-price and cost-reimbursable contracts will generally decline as a result of any increase to indirect costs. If our rate variance is favorable, the modification of our billing rates will decrease revenue and operating expenses, and increase inventory. In this event, fee percentages on fixed price contracts will generally increase. Fee percentages on cost-reimbursable contracts will generally be unaffected as a result of any reduction to indirect costs, due to the fact that programs will typically expend all of the funds available. Any impact on operating income, however, will depend on a number of other factors, including mix of contract types, contract terms, anticipated performance on specific contracts, and anticipated changes in inventory.

Accounts receivable. Accounts receivable are segregated between billed and unbilled accounts. For cost-reimbursement contracts, we bill actual labor, materials, and estimated indirect costs, and a portion of our fees on a regular basis. Under fixed-price contracts, we either regularly progress bill 90% of incurred costs or bill contract costs on a milestone or unit of delivery basis. Unbilled amounts result from recognition of contract revenue in advance of contractual billing or progress billing terms.

Income taxes. Our income tax expense at interim reporting periods is based on an estimated effective tax rate. This estimated tax rate is calculated based on the projected net income at the end of the fiscal year, and is reviewed at each reporting period. At the end of the fiscal year, income tax expense is adjusted for actual results. Our effective tax rate can differ from the statutory rate as a result of expected benefits from R&D credits and the reversals of valuation allowances. Please refer to "Notes to Condensed Financial Statements, Note 5: Provision for Income Taxes" for the current year effective tax rate.

Price Redetermination

As a government contractor, we are subject to price redetermination on certain fixed-price contracts if the government determines that we did not price our products and services consistent with the requirements of the Federal Acquisition Regulations. During the first six months of fiscal years 2004 and 2003, we did not incur any price redeterminations on any of our contracts.

Cash Equivalents and Investments

We consider all highly liquid debt instruments purchased with an original maturity date of three months or less to be cash equivalents.

Short-term investments include all securities that are classified as available-for-sale and are carried at fair market value. At the time of purchase, management determines the appropriate classification of these securities and re-evaluates such designation as of each balance sheet date. Unrealized gains and losses, net of tax, are reported in shareholders equity as part of retained earnings. The cost of securities sold is based on the specific identification method. Realized gains and losses on sales of available-for-sale securities were not material in the first six months of fiscal years 2004 and 2003.

The October 31, 2002 balance sheet was changed in our Annual Report on Form 10-K for our fiscal year ended October 31, 2003 in order to correct a misclassification between cash equivalents and short-term investments. The misclassification had no impact on our statement of operations for any period. The statement of cash flows for the first six months of fiscal year 2003 has been changed in this report to reflect the correct beginning cash balance for fiscal year 2003.

The following tables summarize our cash, cash equivalents, and short-term securities (in thousands):

April 30, 2004

	Amortized Cost	**Gross Unrealized Gains**	**Gross Unrealized Losses**	Estimated Fair Market Value
Cash and cash equivalents	$26,881	$	$	$26,881
Short-term, available-for-sale securities:				
Asset-backed securities	7,046	2	(8)	7,040
Corporate securities	4,715	3	(3)	4,715
Government securities	7,793	2	(2)	7,793
Money market securities	1,591			1,591
	$48,026	$7	($13)	$48,020

	October 31, 2003			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Market Value
Cash and cash equivalents	$5,372	$	$	$5,372
Short-term, available-for-sale securities:				
Asset-backed securities	7,255	9	(4)	7,260
Corporate securities	8,996	38	(4)	9,030
Government securities	16,442	43	(17)	16,468
Money market securities	1,989			1,989
	$40,054	$90	($25)	$40,119

The following table summarizes the maturities of our investments (in thousands):

	April 30, 2004	October 31, 2003
Due in one year or less	$16,903	$18,100
Due in one to three years	4,236	16,647
	$21,139	$34,747

Per Share Data

Basic net income per share is determined by dividing net income by the weighted average number of common shares outstanding during the period. Diluted net income per share is determined by dividing net income by the weighted average number of common shares used in the basic earnings per share calculation, plus the number of common shares that would be issued assuming conversion of all potentially dilutive securities outstanding under the treasury stock method.

The per share data is as follows (in thousands, except per share amounts):

	Three Months Ended		Six Months Ended	
	April 30, 2004	May 2, 2003	April 30, 2004	May 2, 2003
Numerator:				
Net income	$ 3,937	$ 2,227	$ 6,093	$ 4,012
Denominator:				
Shares used to compute net income per common share basic	10,990	10,062	10,922	10,262
Effect of dilutive stock options	575	338	578	265
Shares used to compute net income per common share diluted	11,565	10,400	11,500	10,527
Net income per common share basic	$ 0.36	$ 0.22	$ 0.56	$ 0.39

Net income per common share diluted	$ 0.34	$ 0.21	$ 0.53	$ 0.38

We excluded approximately 5,000 and 50,000 antidilutive potential common shares from diluted net income per common share computation for the second quarter and first six months of fiscal year 2004, respectively. For the same periods in fiscal year 2003 we excluded approximately 181,000 and 403,000 antidilutive potential common shares from diluted net income per common share computation.

Comprehensive Income

The components of comprehensive income, net of tax, are as follows (in thousands):

	Three Months Ended		Six Months Ended	
	April 30, 2004	May 2, 2003	April 30, 2004	May 2, 2003
Net income	$ 3,937	$ 2,227	$ 6,093	$ 4,012
Unrealized gain (loss) on securities	(73)	30	(71)	60
Comprehensive income	$ 3,864	$ 2,257	$ 6,022	$ 4,072

As of April 30, 2004, net unrealized loss on securities was approximately $6,000. As of October 31, 2003, net unrealized gain on securities was approximately $65,000.

Dividends

As of April 30, 2004, we have an annual dividend of $0.50 per share, payable over four quarters at the rate of $0.125 per share per quarter. Dividends were paid on February 13, 2004 and May 14, 2004, and are payable on August 13, 2004 and November 12, 2004 for shareholders of record at January 30, 2004, April 30, 2004, July 30, 2004, and October 31, 2004, respectively, and on such future dates that the Board of Directors may determine.

We paid dividends of approximately $2,044,000 during the first six months of fiscal year 2004. We did not pay any dividends during the first six months of fiscal year 2003.

At April 30, 2004 and October 31, 2003, accrued dividends of approximately $1,376,000 and $673,000, respectively, were included in other accrued liabilities in the accompanying balance sheet.

Stock-Based Compensation

We apply Accounting Principles Board Opinion No. 25 and related Interpretations in accounting for our stock option plans. We have opted, under SFAS No. 123, *Accounting for Stock-Based Compensation*, as amended by SFAS 148, to disclose our stock-based compensation with no financial statement effect. Under APB 25, no stock-based compensation expense is charged for options granted at an exercise price equal to the fair market value of the underlying common stock on the date of grant. Had compensation expense for our stock plans been determined based upon the fair value at the grant date for awards under these plans consistent with the methodology prescribed under SFAS 123, our pro forma net income and net income per share would have been as follows (in thousands, except per share data):

	Three Months Ended		Six Months Ended	
	April 30, 2004	May 2, 2003	April 30, 2004	May 2, 2003
Net income, as reported	$ 3,937	$ 2,227	$ 6,093	$ 4,012
Deduct: total stock-based compensation expense determined at the fair value for all awards	(673)	(305)	(1,276)	(849)
Pro forma net income	$3,264	$1,922	$4,817	$3,163
Net income per share				
Basic As reported	$ 0.36	$ 0.22	$ 0.56	$ 0.39
Pro forma	$ 0.30	$ 0.19	$ 0.44	$ 0.31
Diluted As reported	$ 0.34	$ 0.21	$ 0.53	$ 0.38
Pro forma	$ 0.28	$ 0.18	$ 0.42	$ 0.30

Note 2: Inventory

The components of inventory consist of the following (in thousands):

	April 30, 2004	October 31, 2003
Raw materials	$1,027	$775
Work in process	3,670	5,603
Finished goods	422	494
	5,119	6,872
Precontract costs	750	3
	$5,869	$6,875

At April 30, 2004, the favorable inventoried indirect rate variance reduced work in process by approximately $2,572,000. At May 2, 2003, the unfavorable inventoried indirect rate variance increased work in process by approximately $440,000. For further information on our accounting policy for this inventoried variance, see "Notes to Condensed Financial Statements, Note 1: Summary of Significant Accounting Policies."

Precontract costs represent costs incurred in anticipation of specific expected future contract awards, and cost incurred in connection with ongoing contracts for which contract modifications have not been defined.

We provide advanced digital signal processing products and systems to the US government. Typical life cycles of these products are eight to ten years or more. In addition, we maintain spare parts in order to repair the equipment. We evaluate our inventory quarterly at interim reporting periods, and assess our ability to sell the equipment. Historically, we have sold our inventory at full cost so there is no decrement in valuation. If it is determined that the product has reached the end of its life cycle or there is no longer a need for the equipment, the remaining inventory is scrapped. Historically, we dispose of inventory at approximately the same time that the scrap is recorded and we do not hold inventory reserves.

The charges associated with disposed work in process and finished goods are included in contract costs in our Statement of Operations. Raw material that is disposed of represents a minor amount of scrap and is included in general and administrative expenses on the Statement of Operations due to the fact that raw materials could be used in a variety of situations other than contract costs, including R&D.

Inventory activities during the first six months of fiscal year 2004 and fiscal year 2003 included the scrapping of approximately $1,000,000 and $104,000, respectively, of obsolete products. The scrapped items included units in various stages of completion.

Note 3: Line of Credit

At April 30, 2004, we had a cash-secured line of credit with a bank in the amount of $2,000,000. Borrowings under the line of credit bear interest at the bank s reference rate (4.00% at April 30, 2004) and accrued interest on those borrowings were payable monthly**.** There were no fees associated with the unused portion of the committed amount. The line of credit will expire on March 1, 2005.

Under the line of credit we had two standby letters of credit totaling approximately $1,370,000. One letter of credit, related to our facilities lease, was approximately $1,220,000 at April 30, 2004 and $1,218,000 at October 31, 2003. The second letter of credit was obtained during the first quarter of fiscal year 2004 as a requirement of our workers compensation insurance, and was approximately $150,000 at April 30, 2004. At both April 30, 2004 and October 31, 2003, there were no other borrowings.

Note 4: Segment Reporting

The financial information relating to Applied Signal Technology is reviewed and evaluated by the chief operating decision-maker as a whole. Divisional financial information is not available below the gross margin level. Thus, there is only one reportable segment during the first six months of fiscal years 2004 and 2003.

Note 5: Provision for Income Taxes

Our provision for income taxes for the first six months of fiscal year 2004 was approximately $2,073,000, and included a reduction to income tax expense of approximately $803,000 associated with the reversal of our valuation allowance on our deferred tax assets. This reduction lowered our effective tax rate for the second quarter and first six months of fiscal year 2004 to 18.8% and 25.4%, respectively. We estimate that our tax rate for each of the two remaining quarters could be 35% or greater, which could result in an annual tax rate in the range of 30% to 35%. Our provision for income taxes for the first six months of fiscal year 2003 was approximately $708,000, representing an effective tax rate of 15%. Our projected annual effective tax rate for fiscal year 2003 differed from the statutory rate primarily due to anticipated benefits from the utilization of deferred tax assets.

Note 6: Contingencies

Product Warranties

Our products, including associated firmware and software, are warranted against defective workmanship and materials for a period of one year from the date of acceptance by the original purchaser. In addition, we offer extended warranties at a cost equal to a percentage of the purchase price. An additional six-month warranty may be purchased for 3% of the unit or system purchase price. Alternatively, one-year warranty coverage is 5% of the unit or system purchase price. Warranty costs were approximately $31,000 and $72,000 for the second quarter and first six months of fiscal year 2004, respectively. Fiscal year 2003 warranty costs were approximately $46,000 and $89,000 during the second quarter and first six months, respectively.

Item 2: Management s Discussion and Analysis of Financial Condition and Results of Operations

The following information should be read in conjunction with the attached condensed financial statements and notes thereto, as well as our Annual Report on Form 10-K for the year ended October 31, 2003.

This quarterly report on Form 10-Q contains forward-looking statements made pursuant to the provisions of Section 21E of the Securities Exchange Act of 1934. These forward-looking statements are based on management s current expectations and beliefs, including estimates and projections about our industry. Forward-looking statements may be identified by the use of terms such as "anticipates," "expects," "intends," "plans," "seeks," "estimates," "believes," and similar expressions, although some forward-looking statements are expressed differently.

Statements concerning financial position, business strategy, and plans or objectives for future operations are forward-looking statements. These statements are not guarantees of future performance and are subject to certain risks, uncertainties, and assumptions that are difficult to predict and may cause actual results to differ materially from management s current expectations. Such risks and uncertainties include those set forth in this document under "Summary of Business Considerations and Certain Factors that May Affect Future Operating Results and/or Stock Price." The forward-looking statements in this report speak only as of the time they are made and do not necessarily reflect management s outlook at any other point in time. We undertake no obligation to update publicly any forward-looking statements, whether as a result of new information, future events, or for any other reason. However, readers should carefully review the risk factors set forth in other reports or documents we file from time to time with the Securities and Exchange Commission (SEC).

Description of the Business

Applied Signal Technology, Inc. provides advanced digital signal processing products, systems, and services used in reconnaissance of telecommunications signals for intelligence gathering, a process referred to as signal intelligence. Our primary customer is the United States Government. We develop and manufacture equipment for both the collection and processing of signals. Our signal collection equipment consists of sophisticated receivers that scan through potentially thousands of cellular telephone, microwave, ship-to-shore, and military transmissions in the radio frequency (RF) spectrum with the goal of collecting certain specific signals. Our signal processing equipment uses advanced software and hardware to evaluate characteristics of the collected signals and selects those most likely to contain relevant information. At inception, our efforts were primarily focused on processing equipment. Over time, we have broadened our scope to add specialized collection equipment and complete signal processing systems.

We were incorporated in California in 1984. Our principal executive offices are located at 400 West California Ave., Sunnyvale, CA, 94086, and our telephone number is (408) 749-1888. Our web site address is www.appsig.com. The information posted on our web site is not incorporated into this quarterly report. However, investors can obtain a copy of this report, previous quarterly reports on Form 10-Q, our latest Annual Report on Form 10-K, current reports on Form 8-K, and amendments to such reports filed or furnished with the SEC on our web site free of charge. In addition, hard copies can be obtained free of charge through our investor relations department.

Critical Accounting Policies and Estimates

General. Our discussion and analysis of our financial condition and results of operations are based upon our financial statements. These financial statements are prepared in accordance with accounting principles generally accepted in the United States, which require management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ significantly from those estimates. We believe that the estimates, assumptions, and judgments involved in the accounting policies described below have the greatest potential impact on our financial statements and, therefore, consider these to be critical accounting policies. See Note 1 to condensed financial statements included elsewhere in this report for more information about these critical accounting policies, as well as descriptions of other significant accounting policies.

Revenue and cost recognition. The majority of our contracts are accounted for in accordance with the American Institute of Certified Public Accountants Statement of Opinion 81-1, *Accounting for Performance of Construction-Type and Production-Type Contracts.* These contracts are executed using written contractual arrangements, most of which require us to design, develop, manufacture and/or modify our complex products, and perform related services according to specifications provided by the customer.

We account for cost-reimbursement contracts by charging actual labor, materials, and other direct costs, plus estimated indirect costs of operations as incurred. Indirect costs include overhead, research and development, and general and administrative expenses. General and administrative costs are not applied to certain subcontract costs associated with our cost-reimbursable contracts. These subcontracts must be in excess of $250,000 and must meet certain other predetermined criteria. We recognize contract revenues and profits on cost-reimbursement contracts by applying an estimated fee rate to all costs incurred on an individual contract basis. Fee calculations are based on either negotiated fee amounts or management s assessment of the fee amounts that are likely to be earned.

Our policy for recognizing interim fees on our cost-plus-award-fee contracts is based on management s assessment as to the likelihood that the award fee or an incremental portion of the award fee will be earned, on a contract-by-contract basis. Management s assessments are based on numerous factors including: contract terms, nature of the work to be performed, our relationship and history with the customer, our history with similar types of projects, and our current and anticipated performance on the specific contract. No award fee is recognized until management determines that it is probable that an award fee or a portion thereof will be earned. Management s estimates are typically consistent with actual fees awarded. However, changes could arise within an award fee period causing management to either lower or raise the award fee estimate in the period in which it occurs.

Our engineering services contracts are typically performed on a level-of-effort basis. Revenue is recognized in accordance with our policy regarding cost-reimbursement contracts.

We account for fixed-price contracts by using the percentage-of-completion method of accounting. Under this method, labor, materials, and other direct costs, plus estimated indirect costs of operations are charged as incurred. A portion of the contract revenue, based on estimated profits and the degree of completion of the contract as measured by a comparison of the actual and estimated costs, is recognized as revenue each period.

For those contracts in which all of the terms have not yet been finalized, revenue does not include an estimated fee rate on cost.

Management reviews contract performance, costs incurred, and estimated completion costs regularly. Revenues and profits are adjusted on all contracts in the period in which changes, including anticipated losses, become determinable. Unexpected increases in the cost to develop or manufacture a product, whether due to inaccurate estimates in the bidding process, unanticipated increases in material costs, inefficiencies, or other factors, are borne by us on fixed-price contracts, and could have a material adverse effect on results of operations and financial condition. Unexpected cost increases in cost-reimbursement contracts may be borne by us for purposes of maintaining customer relationships. Historically, the effect on operating results and financial condition from cost-reimbursement losses has been minimal.

Indirect rate variance adjustment to operations. We record contract revenues and costs of operations for interim reporting purposes based on annual targeted indirect rates. During our interim reporting periods, variances may accumulate between the actual indirect rates and the annual targeted rates. All timing-related indirect spending variances are removed from contract costs, research and development, and general and administrative expenses and are included in inventory as part of work in process during these interim reporting periods. These rates are reviewed regularly, and we record adjustments for any material, permanent variances in the period they become determinable. We have determined that this estimate is the preferred practice used within our industry. At year-end, the revenues and costs are adjusted for actual indirect rates.

Our accounting policy for recording the indirect rate variance is based on management s belief that variances accumulated during interim reporting periods will be absorbed by expected contract activities during the remainder of the year. We consider the rate variance to be unfavorable when our actual indirect rates are greater than our annual targeted rates. In contrast, a favorable rate variance occurs when our actual indirect rates are lower than our annual targeted rates. During interim reporting periods, unfavorable rate variances are recorded as reductions to operating expenses and increases to work in process inventory. Favorable rate variances are recorded as increases to operating expenses and decreases to work in process inventory.

If we anticipate that actual contract activities will be different than planned levels, there are alternatives we can utilize to reduce the variance: we can adjust some of our planned indirect spending during the year, modify our billing rates to our customers, or record adjustments to expense based on estimates of future contract activities. At April 30, 2004, the favorable inventoried indirect rate variance was approximately $2,572,000. At May 2, 2003, the unfavorable inventoried rate variance was approximately $440,000.

If our rate variance is unfavorable, the modification of our billing rates will likely increase revenue and operating expenses, and decrease inventory. Fee percentages on fixed-price and cost-reimbursement contracts will generally decline as a result of any increase to indirect costs. If our rate variance is favorable, the modification of our billing rates will decrease revenue and operating expenses, and increase inventory. In this event, fee percentages on fixed-price contracts will generally increase. Fee percentages on cost-reimbursable contracts will generally be unaffected as a result of any reduction to indirect costs, due to the fact that programs will typically expend all of the funds available. Any impact on operating income, however, depends on a number of other factors, including mix of contract types, contract terms, and anticipated performance on specific contracts, and anticipated changes in inventory.

We expect to absorb the current positive indirect rate variance through certain contract activities. However, if these activities do not absorb the positive indirect rate variance, we may have to modify our billing rates during the remaining six months of fiscal year 2004. In the event that our rates decline, our revenues and contract costs could decline creating a marginal increase in fees, overall. This is due to the fact that we believe our largest portion of revenues will be from cost-reimbursement contracts, whose fee percentages will be unaffected, since these programs will likely expend the total funds available. However, we also believe that we will experience a marginal increase in operating income due to the increased profitability on our fixed-price contracts.

Income taxes. Our income tax expense at interim reporting periods is based on an estimated effective tax rate. This estimated tax rate is calculated based on the projected net income at the end of the fiscal year, and is reviewed at each reporting period. At the end of the fiscal year, income tax expense is adjusted for actual results. Our effective tax rate can differ from the statutory rate as a result of expected benefits from R&D credits and the reversals of valuation allowances.

Price Redetermination. As a government contractor, we are subject to price redetermination on certain fixed-price contracts if it is determined that we did not price our products and services consistent with the requirements of the Federal Acquisition Regulations. During the first six months of fiscal years 2004 and 2003, we did not incur any price redeterminations on any of our contracts.

Overview

As of April 30, 2004, we continue to believe that there is a renewed interest in signal intelligence by the US government to respond to the threat of terrorist activities and the war against terrorism. We also believe that our company is well positioned to benefit from the spending that might result.

A significant portion of our revenue is generated by cost-reimbursable contracts. These contracts tend to be developmental in nature, and require highly specialized, technical skill sets. We believe that this trend will continue through the end of fiscal year 2004.

Three and Six Months Ended April 30, 2004 Compared to Three and Six Months Ended May 2, 2003

Revenues and backlog. Revenues for the second quarter of fiscal year 2004 were approximately $36,811,000, a 66.7% increase from revenues of approximately $22,081,000 recorded in the second quarter of fiscal year 2003. Revenues for the first six months of fiscal year 2004 were approximately $65,105,000, a 61.7% increase from revenues of approximately $40,259,000 recognized during the first six months of fiscal year 2003. It is our belief that the increase in revenues recorded during the second quarter and first six months of fiscal year 2004, when compared to the same periods in fiscal year 2003, is due to an emphasis by the US government on intelligence to support the war against terrorism.

New orders received for the second quarter and first six months of fiscal year 2004 were approximately $28,636,000, and $93,185,000, respectively, compared to approximately $19,479,000 and $31,523,000 received during the same periods in fiscal year 2003. New orders were greater during the second quarter of fiscal year 2004 when compared to the second quarter of fiscal year 2003 due to what we believe to be the US government s emphasis on intelligence. The significant increase in new orders during the first six months of fiscal year 2004 was primarily due to a major modification of our largest contract.

Our backlog consists of the uncompleted portions of existing contracts (excluding unexercised options). At April 30, 2004, ending backlog was approximately $113,832,000, representing a 30.7% increase from ending backlog of approximately $87,074,000 at October 31, 2003.

Cost-reimbursement contracts typically do not return as high a profit margin as fixed-price contracts and accordingly our profit margin will be affected by the mix of our orders by contract type. The following table represents the revenue concentration by contract type:

	Three Months Ended		Six Months Ended		Twelve Months Ended
	April 30, 2004	May 2, 2003	April 30, 2004	May 2, 2003	October 31, 2003
Cost-reimbursement contracts	76%	77%	75%	75%	77%
Fixed-price contracts	24%	23%	25%	25%	23%

We currently anticipate that the mix of contract types for fiscal year 2004 will be similar to that experienced in fiscal year 2003.

Our single largest contract represented 21% of revenues for the second quarter and first six months of fiscal year 2004. For the second quarter and first six months of fiscal year 2003 our single largest contract represented 22% and 20% of revenues, respectively. In addition, another significant program represented approximately 10% and 9% for the second quarter and first six months of fiscal year 2004, respectively. This program did not recognize any revenues during the same periods of fiscal year 2003, since it did not begin until the fourth quarter of fiscal year 2003.

Contract costs. Contract costs consist of direct costs incurred in the performance of the contract, including labor, materials, and estimated overhead costs. Contract costs were approximately $24,146,000, or 65.6%, of revenues for the second quarter of fiscal year 2004 compared to approximately $13,856,000, or 62.8%, of revenues for the same period of fiscal year 2003. During the first six months of fiscal year 2004, we incurred contract costs of approximately $42,446,000, or 65.2% of revenues, compared to contract costs incurred during the first six months of fiscal year 2003 of approximately $25,412,000, or 63.1% of revenues. Contract costs increased as a percentage of revenue during the first six months of fiscal year 2004 primarily due to the mix of program types. In addition, contract costs, as a percentage of revenues during the first six months of fiscal year 2004, were within historical levels.

Research and development (R&D). Company-directed investment in research and development consists of expenditures recoverable from customers through our billing rates and expenditures funded from earnings. For interim reporting periods R&D expenses include labor, materials and estimated overhead costs, R&D expenses were approximately $3,419,000, or 9.3%, of revenues for the second quarter of fiscal year 2004 compared to approximately $1,900,000, or 8.6%**,** of revenues for the same period of fiscal year 2003. During the first six months of fiscal year 2004, R&D expenses were approximately $5,556,000, or 8.5%, of revenues compared to approximately $3,601,000, or 8.9%, of revenues incurred during the first six months of fiscal year 2003. R&D expenses grew in absolute dollars based on management s decision to try to maintain R&D spending as a percent of projected revenues at levels comparable to historical levels.

General and administrative. General and administrative expenses include administrative salaries, costs related to marketing and proposal activities, costs associated with product warranties, and other administrative costs. We record general and administrative expenses based on annual targeted indirect rates applied to the quarterly revenue base, for interim reporting periods. General and administrative expenses were approximately $4,534,000, or 12.3%, of revenues for the second quarter of fiscal year 2004 compared to approximately $3,805,000, or 17.2%, of revenues for the same period of fiscal year 2003. General and administrative expenses incurred during the first six months of fiscal year 2004 were approximately $9,215,000, or 14.2%, of revenues compared to approximately $6,726,000, or 16.7%, of revenues incurred during the first six months of fiscal year 2003. General and administrative expenses were higher in absolute dollars during the second quarter and first six months of fiscal year 2004 primarily due to our annual targeted indirect rate applied to a higher revenue base. General and administrative expenses were lower as a percentage of revenue due to our ability to significantly grow revenues without having to proportionately increase our general and administrative expenditures. However, we believe that our rapid growth in revenue could cause additional general and administrative expenditures during the remaining six months of fiscal year 2004, and bring general and administrative expenses up to historical levels by the end of fiscal year 2004.

Product warranties. Our products, including associated firmware and software, are warranted against defective workmanship and materials for a period of one year from the date of acceptance by the original purchaser. In addition, we offer extended warranties as a percentage of the purchase price. An additional six-month warranty may be purchased for 3% of the unit or system purchase price. Alternatively, one-year warranty coverage is 5% of the unit or system purchase price. Warranty costs were approximately $31,000 and $72,000 for the second quarter and first six months of fiscal year 2004, respectively. Fiscal year 2003 warranty costs were approximately $46,000 and $89,000 during the second quarter and first six months, respectively.

Interest income (expense), net. Net interest income for the second quarter of fiscal year 2004 was approximately $137,000 compared to net interest income of approximately $100,000 for the second quarter of fiscal year 2003. Net interest income recognized during the first six months of fiscal year 2004 was approximately $278,000 compared to approximately $200,000 recognized during the same period of fiscal year 2003. Interest income increased during the second quarter and first six months of fiscal year 2004 as a result of higher cash and investment balances at the beginning of fiscal year 2004 when compared to the beginning of fiscal year 2003.

Provision for income taxes. Our provision for income taxes for the first six months of fiscal year 2004 was approximately $2,073,000 and included a reduction of approximately $803,000 of income tax expense associated with the reversal of our valuation allowance on our deferred tax assets. This reduction lowered our effective tax rate for the second quarter and first six months of fiscal year 2004 to 18.8% and 25.4%, respectively. We estimate that our tax rate for each of the two remaining quarters could be 35% or greater, which could result in an annual tax rate in the range of 30% to 35%. Our provision for income taxes for the first six months of fiscal year 2003 was approximately $708,000, representing an effective tax rate of 15%. Our provision for income taxes for the first six months of fiscal year 2003 was approximately $708,000, representing an effective tax rate of 15%. Our projected annual effective tax rate for fiscal year 2003 differed from the statutory rate primarily due to anticipated benefits from the utilization of deferred tax assets.

Analysis of Liquidity and Capital Resources

Our primary sources of liquidity during the first six months of fiscal year 2004 were cash flows generated from operations and the issuance of common stock through our employee stock option plans and purchase plan.

The October 31, 2002 balance sheet was changed in our Annual Report on Form 10-K for our fiscal year ended October 31, 2003 in order to correct a misclassification between cash equivalents and short-term investments. The misclassification had no impact on our statement of operations for any period. The statement of cash flows for the first six months of fiscal year 2003 has been changed in this report to reflect the correct beginning cash balance for fiscal year 2003.

Net cash from operating activities. Net cash provided by operating activities has varied significantly from quarter to quarter. These quarter-to-quarter variances are primarily the result of changes in net income and operating assets and liabilities. Operating activities provided approximately $9,222,000 and $8,275,000 during the first six months of fiscal years 2004 and 2003, respectively. Net income for the first six months of fiscal year 2004 was approximately $6,093,000 compared to a net income of approximately $4,012,000 for the comparable period of fiscal year 2003. This increase in net income is due in part to our growth in revenues and in part to an increase in program profitability at the completion of certain production programs.

Accounts receivable balances increased during the first six months of fiscal year 2004 by approximately $4,245,000, whereas during the comparable period of fiscal year 2003 accounts receivable balances decreased by approximately $4,033,000. Accounts receivable balances increased during the first six months of fiscal year 2004 due to the significant revenue generated during this period. In contrast, the revenues generated during the first six months of fiscal year 2003 were less than the cash received on collections of accounts receivable, which caused our accounts receivable balances to decrease during the first six months of fiscal year 2003. The significant amount of cash received during the first six months of fiscal year 2003 was primarily the result of an improved payment process of one of our significant customers.

Cash used to support inventory, prepaid expenses, and other assets was approximately $400,000 and $3,012,000 during the first six months of fiscal years 2004 and 2003, respectively. The primary fluctuation in cash used between the first six months of fiscal year 2004 and the first six months of fiscal year 2003 is due to the difference in the rate variance between those two periods. In the first six months of fiscal year 2004, the favorable rate variance decreased inventory balances by approximately $2,572,000. During the same period of fiscal year 2003, the unfavorable rate variance increased inventory balances by approximately $440,000.

The change in accounts payable, taxes payable and accrued liabilities balances resulted in a net increase of approximately $5,564,000 and $868,000 during the first six months of fiscal years 2004 and 2003, respectively. Income taxes payable increased approximately $2,581,000 during the first six months of fiscal year 2004, compared to no change during the first six months of fiscal year 2003. The difference in the income taxes payable activities between fiscal years 2004 and 2003 is the difference in the effective tax rate (35% for fiscal year to date 2004 and 15% for fiscal year 2003). Accrued payroll liabilities increased approximately $1,009,000 during the first six months of fiscal year 2004 and approximately $509,000 during the first six months of fiscal year 2003. The primary fluctuation between accrued payroll activities is the significant increase to our staff during the first six months of fiscal year 2004, when compared to the same period of fiscal year 2003. Accounts payable and other accrued liabilities increased approximately $1,974,000 and $359,000 during the first six months of fiscal years 2004 and 2003, respectively. The difference between accounts payable activities during the first six months of fiscal years 2004 and 2003 is due to a significant increase in contract activity.

Net cash from investing activities. During the first six months of fiscal year 2004 investing activities provided cash of approximately $11,633,000, and used cash of approximately $13,425,000 during the first six months of fiscal year 2003. The primary difference between fiscal years 2004 and 2003 was the significant proceeds received from the sales of short term investments during the first six months of fiscal year 2004. The company adopted an investment policy with a shorter average maturity date resulting in the sale of longer term securities.

Net cash from financing activities. Financing activities provided cash of approximately $654,000 during the first six months of fiscal year 2004 and approximately $1,263,000 during the same period in fiscal year 2003. The source of cash provided by financing activities in both periods was the issuance of common stock under our employee stock purchase plan and stock option plans. Cash from our stock option exercises increased during the first six months of fiscal year 2004, when compared to fiscal year 2003, by approximately $1,314,000. We believe our employees exercised more options during the first six months of fiscal year 2004 due to the increase in market value of our common stock. However, cash from the issuance of common stock in the first six months of fiscal year 2004 was offset by dividend payments of $2,044,000. We did not pay any dividends during the first six months of fiscal year 2003.

Cash is generated primarily from operating activities, employee stock activities, and investing activities. Our investment portfolio includes a variety of low-risk investments. We believe the primary risk to liquidity is the potential decrease in demand for our products and services. Historically, this demand has been influenced by the needs of the United States intelligence community.

At April 30, 2004, we had a cash-secured line of credit with a bank in the amount of $2,000,000. Borrowings under the line of credit bear interest at the bank s reference rate (4.00% at April 30, 2004) and accrued interest on those borrowings were payable monthly. There were no fees associated with the unused portion of the committed amount. This line of credit will expire on March 1, 2005.

Under the line of credit we had two standby letters of credit totaling approximately $1,370,000. One letter of credit, related to our facilities lease, was approximately $1,220,000 and $1,218,000 at April 30, 2004 and October 31, 2003, respectively. The second letter of credit was obtained during the first quarter of fiscal year 2004 as a requirement of our workers compensation insurance, and was approximately $150,000 at April 30, 2004. At both April 30, 2004 and October 31, 2003, there were no other borrowings.

We believe that the funds generated from operations, existing working capital, and the amount available under our existing line of credit will be sufficient to meet our cash needs for the next twelve months.

Summary of Business Considerations and Certain Factors That May Affect Future Results of Operations and/or Stock Price

Our future performance is subject to a variety of risks. If any of the following risks actually occur, our business could be harmed and the trading price of our common stock could decline. In addition to the following disclosures, please refer to the other information contained in this report, including financial statements and the related notes.

Any reduction in government spending on signal intelligence could materially adversely impact our revenues, results of operations, and financial condition. Historically, defense and intelligence agencies of the United States Government have accounted for almost all of our revenues. There are risks associated with programs that are subject to appropriation by Congress, which could be potential targets for reductions in funding to pay for other programs. Future reductions in United States Government spending on signal intelligence or future changes in the kind of signal intelligence products or services required by the United States Government agencies could limit demand for our products and services, which would have a material adverse effect on our operating results and financial condition.

Also, potential shifts in responsibilities and functions within the defense and intelligence communities could result in a reduction of orders for signal intelligence by the defense and intelligence agencies that have historically been our major customers. We believe that the United States Government may compensate for reduced order flow by these agencies with increases in spending for signal intelligence by other Government agencies. However, our relationships with other Government agencies are not as strong as our relationships with current customer agencies. A reduction in contracts from our customer agencies may not be offset by contracts from other United States Government agencies. Even if other agencies increase spending for signal intelligence, we may not secure the same amount of work from such other agencies. As a result, demand for our products and services could decline, resulting in a decrease in revenues, and could adversely affect our operating results and financial condition materially.

If we are unable to comply with complex government regulations governing security and contracting practices, we could be disqualified as a supplier to the United States Government. As a supplier to United States Government defense and intelligence agencies, we must comply with numerous regulations, including those governing security and contracting practices. Failure to comply with these procurement regulations and practices could result in fines being imposed against us or our suspension for a period of time from eligibility for bidding on, or for award of, new government contracts. If we are disqualified as a supplier to government agencies, we will lose most, if not all, of our customers, revenues from sales of our products would decline significantly, and our ability to continue operations would be seriously jeopardized. Among the causes for disqualification are violations of various statutes, including those related to procurement integrity, export control, US government security regulations, employment practices, protection of the environment, accuracy of records in the recording of costs, and foreign corruption. The government may investigate and make inquiries of our business practices and conduct audits of contract performance and cost accounting. Depending on the results of these audits and investigations, the government may make claims against us, and if they prevail, certain incurred costs would not be recoverable.

We depend on revenues from a few significant contracts, and any loss, cancellation, reduction, or delay in these contracts could harm our business. From time to time, including recent periods, we have derived a material portion of our revenue from one or more individual contracts that could be terminated by the customer at the customer s discretion. We expect that in future periods we may again enter into individual contracts with significant revenue concentrations. If such contracts were terminated, revenues and net income would significantly decline. Our success will depend on our continued ability to develop and manage relationships with significant customers. Although we are attempting to expand our customer base, we expect that our customer concentration will not change significantly in the near future. The markets in which we sell our products are dominated by a relatively small number of governmental agencies and allies of the United States Government, thereby limiting the number of potential customers. Our dependence on large orders from a relatively small number of customers makes our relationship with each customer critical to our business. We cannot be sure that we will be able to retain our largest customers, that we will be able to attract additional customers, or that our customers will continue to buy our products in the same amounts as in prior years. The loss of one or more of our largest customers, any reduction or delay in sales to these customers, our inability to successfully develop relationships with additional customers, or future price concessions that we may have to make could significantly harm our business.

Continued competition in our markets may lead to a reduction in our revenues and market share. The signal intelligence market is highly competitive and we expect that competition will increase in the future. Our current competitors have significantly greater technical, manufacturing, financial, and marketing resources than we do. We expect that more companies will enter the market for signal intelligence. We may not be able to compete successfully against either current or future competitors. Increased competition could result in reduced revenue, lower margins, or loss of market share, any of which could significantly harm our business. Our competitors may introduce improved products with lower prices, and we will have to do the same to remain competitive.

If we are unable to recruit, train, and retain key personnel with required security clearances, our ability to develop, introduce, and sell our products may be adversely impacted. Our ability to execute our business plan is contingent upon successfully attracting and retaining qualified employees who obtain, or are able to obtain, necessary government security clearances. If we fail to attract and retain qualified employees who can obtain the necessary security clearances, our business could be significantly harmed. The loss of the services of any of our qualified employees, the inability to attract or retain qualified personnel in the future, or delays in hiring required personnel could negatively impact our ability to develop, introduce, and sell our products. In addition, employees may leave us and subsequently compete against us.

Many of the personnel we hire will need US government security clearances in order to perform tasks we require on our government contracts. We have found that there is a shortage of qualified personnel possessing the necessary clearances, and new security clearances are taking longer to be granted. If we are not able to obtain security clearances for our personnel where required, they will be unable to perform tasks requiring clearances, and we may be unable to satisfy the terms of our contracts, resulting in customer dissatisfaction and possible loss of current or future contracts.

Unexpected increases in the cost to develop or manufacture our products under fixed-price contracts may cause us to experience unreimbursed cost overruns. A significant portion of our revenue is derived from fixed-price contracts. Under fixed-price contracts, unexpected increases in the cost to develop or manufacture a product, whether due to inaccurate estimates in the bidding process, unanticipated increases in materials costs, inefficiencies, or other factors, are borne by us. We have experienced cost overruns in the past that have resulted in losses on certain contracts, and may experience additional cost overruns in the future. Such cost overruns would increase our operating expenses, reduce our net income and earnings per share, and have a materially adverse effect on our future results of operations and financial condition.

Unexpected contract terminations could negatively impact our operating results and financial condition. Almost all of our contracts contain termination clauses that permit contract termination upon our default or for the convenience of the other contracting party. In either case, termination could adversely affect our operating results and financial condition. For example, in fiscal year 2001, we received unanticipated contract closeout notifications on three significant engineering contracts for the convenience of the other contracting party. These closeouts contributed, in part, to our need to reduce our cost structure during fiscal year 2001. There were no such notifications in subsequent years.

Our future revenues are inherently unpredictable, our operating results are likely to fluctuate from period to period, and if we fail to meet the expectations of securities analysts or investors, our stock price could decline significantly. Our quarterly and annual operating results have fluctuated in the past and are likely to fluctuate significantly in the future due to a variety of factors, some of which are outside our control. Accordingly, we believe that period-to-period comparisons of our results of operations are not meaningful and should not be relied upon as indications of future performance. Some of the factors that could cause our quarterly or annual operating results to fluctuate include conditions inherent in government contracting and our business such as the timing of cost and expense recognition for contracts, the United States Government contracting and budget cycles, and contract closeouts. Because we base our operating expenses on anticipated revenue trends and a high percentage of our expenses are fixed in the short term, any delay in generating or recognizing forecasted revenues could significantly harm our business. Fluctuations in quarterly results, competition, or announcements of extraordinary events such as acquisitions or litigation may cause revenues to fall below the expectations of securities analysts and investors. In this event, the trading price of our common stock could significantly decline. In addition, there can be no assurance that an active trading market will be sustained for our common stock. The stock market in recent years has experienced extreme price and volume fluctuations that have particularly affected the market prices of many technology companies. These fluctuations, as well as general economic and market conditions, may adversely affect the future market price of our common stock.

Our market is subject to rapid technological change, and to compete effectively, we must continually introduce new products or enhancements that achieve market acceptance. The market for our products is characterized by rapidly changing technology, frequent new product introductions, changes in customer requirements, and evolving industry standards. We believe that we have been successful to date in identifying certain signal intelligence needs early, investing in research and development to meet these needs, and delivering products before our competitors. We believe that our future success will depend upon continued development and timely introduction of products capable of collecting or processing new types of telecommunications signals. However, we expect that new technologies will continue to emerge. Our future performance will depend on the successful development, introduction, and market acceptance of new and enhanced products that address these changes as well as current and potential customer requirements. The introduction of new and enhanced products may cause our customers to defer or cancel orders for existing products. There can be no assurance that we will be able to develop and market new products successfully in the future or respond effectively to technological changes, such as data encryption technology and others, or that new products introduced by others will not render our products or technologies noncompetitive or obsolete.

We also may not be able to develop the underlying core technologies necessary to create new products and enhancements or to license these technologies from third parties. Product development delays may result from numerous factors, including:

- Changing product specifications and customer requirements
- Difficulties in hiring and retaining necessary technical personnel
- Difficulties in reallocating engineering resources and overcoming resource limitations
- Difficulties with contract manufacturers
- Changing market or competitive product requirements
- Unanticipated engineering complexities

The development of new, technologically advanced products is a complex and uncertain process requiring high levels of innovation and highly skilled engineering and development personnel, as well as the accurate anticipation of technological and market trends. We cannot ensure that we will be able to identify, develop, manufacture, market, or support new or enhanced products successfully, if at all, or on a timely basis. Further, we cannot ensure that our new products will gain market acceptance or that we will be able to respond effectively to product announcements by competitors, technological changes, or emerging industry standards. Any failure to respond to technological change would significantly harm our business.

Our results of operations could be negatively impacted if we are required to write off inventory deemed not saleable or usable. Some of our products or raw materials may become obsolete or unusable while in inventory. This could be due to changing customer specifications, decreases in demand for existing products, or changes in government spending on signal intelligence. Work in process deemed not saleable is written off to contract costs in our Statement of Operations, while unusable raw materials are written off to general and administrative expenses.

We may lose sales if our suppliers fail to meet our needs. Although we procure most of our parts and components from multiple sources or believe that these components are readily available from numerous other sources, certain components are available only from sole sources or from a limited number of sources. While we believe that substitute components or assemblies could be obtained, use of substitutes would require development of new suppliers or would require us to re-engineer our products, or both, which could delay shipment of our products and could have a material adverse effect on our operating results and financial condition.

Our headquarters and most of our operations are located in California where natural disasters may occur, resulting in disruption to our business. Our corporate headquarters, including most of our research and development operations and production facilities, are located in the Silicon Valley area of Northern California, a region known for being vulnerable to natural disasters and other risks, such as earthquakes, fires, and floods, which at times have disrupted the local economy and posed physical risks to our property. A significant earthquake could materially affect operating results. We are not insured for most losses and business interruptions of this kind, and do not presently have redundant, multiple site capacity in the event of a natural disaster. In the event of such disaster, our business would suffer.

Delays in the receipt of engineering contracts could negatively impact our business. During our history, we have experienced delays in the receipt of certain contracts. While we work closely with our customers to try to capture what we believe to be sole-source orders, delays in the receipt of such orders could result in revenues falling short of estimates. In addition, gross margins and net income will decrease if we elect to hold our cost structure in place while awaiting the award of delayed contracts.

Our failure to protect our intellectual property may significantly harm our business. Our success and ability to compete is dependent in part on our proprietary technology. We rely on a combination of patent, copyright, trademark, and trade secret laws, as well as confidentiality agreements to establish and protect our proprietary rights. We license certain of our proprietary technology to customers, and we rely largely on provisions of our licensing agreements to protect our intellectual property rights in this technology. To date, we have relied primarily on proprietary processes and know-how to protect our intellectual property. Although we have filed applications for several patents, two of which we currently hold, we cannot ensure that any patents will be issued as a result of pending patent applications or that our issued patents will be upheld. Any infringement of our proprietary rights could result in significant litigation costs, and any failure to adequately protect our proprietary rights could result in our competitors offering similar products, potentially resulting in loss of a competitive advantage and decreased revenues. Despite our efforts to protect our proprietary rights, existing patent, copyright, trademark, and trade secret laws afford only limited protection. In addition, the laws of some foreign countries do not protect our proprietary rights to the same extent as do the laws of the United States. Attempts may be made to copy or reverse engineer aspects of our products or to obtain and use information that we regard as proprietary. Accordingly, we may not be able to prevent misappropriation of our technology or deter others from developing similar technology. Furthermore, policing the unauthorized use of our products is difficult. Litigation may be necessary in the future to enforce our intellectual property rights or to determine the validity and scope of the proprietary rights of others. This litigation could result in substantial costs and diversion of resources, and could significantly harm our business.

Claims that we infringe third-party intellectual property rights could result in significant expenses or restrictions on our ability to sell our products. It is possible that from time to time, other parties may assert patent, copyright, trademark, and other intellectual property rights to technologies and in various jurisdictions that are important to our business. Any claims asserting that our products infringe or may infringe proprietary rights of third parties, if determined adverse to us, could significantly harm our business. Any claims, with or without merit, could result in costly litigation, divert the efforts of our technical and management personnel, cause product shipment delays, or require us to enter into royalty or licensing agreements, any of which could significantly harm our business. Royalty or licensing agreements, if required, may not be available on terms acceptable to us, if at all. In addition, our agreements with our customers typically require us to indemnify our customers from any expense or liability resulting from claimed infringement of third-party intellectual property rights. In the event a claim against us was successful and we could not obtain a license to the relevant technology on acceptable terms, license a substitute technology, or redesign our products to avoid infringement, our business would be significantly harmed.

Item 3: Quantitative and Qualitative Disclosures About Market Risk

Interest rate risk. Our interest income is sensitive to changes in the general level of US interest rates, particularly since the majority of our investments are in short-term instruments. The average maturity of our investment portfolio is 100 days. Due to the short-term nature of these cash investments, we do not believe that there is a material interest rate risk. As of April 30, 2004, our total cash and investments balance that was sensitive to interest rate risk was approximately $48,020,000. The sensitivity of our portfolio is: if yields were to fluctuate by 100 basis points, the total effect to the investment portfolio balance would be approximately $128,000.

The following table summarizes our cash, cash equivalents, and short-term securities, at fair value, that are sensitive to interest rate risk (in thousands):

	April 30, 2004	October 31, 2003
Cash and cash equivalents	$26,881	$5,372
Short-term, available-for-sale securities:		
Asset-backed securities	7,040	7,260
Corporate securities	4,715	9,030
Government securities	7,793	16,468
Money market securities	1,591	1,989
	$48,020	$40,119

Item 4: Controls and Procedures

Evaluation of disclosure controls and procedures. Under the supervision and with the participation of management, including our principal executive officer and principal financial officer, we evaluated the effectiveness of the design and operation of our disclosure controls and procedures, as such term is defined in Rule 13a-15(e) promulgated under the Securities Exchange Act of 1934 (the "Exchange Act"), as amended. Based on this evaluation, our principal executive officer and principal financial officer concluded that our disclosure controls and procedures were effective as of the end of the period covered by this quarterly report.

Changes in internal controls over financial reporting. Since the most recent evaluation of internal controls over financial reporting by our principal executive officer and principal financial officer, there have been no significant changes to these internal controls that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Limitations of the effectiveness of internal controls. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the internal control system are met. Because of the inherent limitations of any internal control system, no evaluation of controls can provide absolute assurance that all control issues, if any, within a company have been detected.

Part II. Other Information

Item 1: Legal Proceedings

We are subject to litigation, from time to time, in the ordinary course of business including, but not limited to, allegations of wrongful termination or discrimination or governmental agency investigations. Although the amount of any liability with respect to such litigation cannot currently be determined, we are not party to any pending legal proceedings, which, in the opinion of management, are material to our business or financial condition. As a government contractor, we may also be subject to investigations by the United States Government for alleged violations of procurement or other federal laws. Under present government procurement regulations, if judged in violation of procurement or other federal civil laws, we could be suspended or barred from eligibility for awards of new government contracts.

Item 2: Changes in Securities, Use of Proceeds, and Issuer Purchases of Equity Securities

None.

Item 3: Defaults Upon Senior Securities

None.

Item 4: Submission of Matter to a Vote of Security Holders

At the annual meeting of our shareholders held on March 10, 2004, the following matters were considered and voted upon:

The following nominees were elected as Class II directors to serve on our Board of Directors for a two-year term expiring at the 2006 annual meeting of stockholders and until their successors are duly elected and qualified. The number of shares voted and withheld for such nominees were as follows:

Name	For	Withheld
Milton E. Cooper	9,370,940	309,103
John R. Treichler	9,349,465	330,578
Stuart G. Whittelsey, Jr.	9,219,796	460,247

A proposal to adopt the 2004 Stock Incentive Plan was approved and ratified by a vote of 6,039,353 shares for, 1,198,397 shares against, and 9,073 shares abstaining.

The appointment of Ernst & Young LLP as our independent auditors for the fiscal year ending October 31, 2004 was approved and ratified by a vote of 9,380,625 shares for, 293,902 shares against, and 5,516 shares abstaining.

Item 5: Other Information

None.

Item 6: Exhibits and Reports on Form 8-K

Exhibits   See Index to Exhibits

Reports on Form 8-K   Reports on Form 8-K filed or furnished during the three months ended April 30, 2004.

- Form 8-K furnished on February 26, 2004 containing the February 24, 2004 press release and conference call transcript related to our announcement of our first quarter results for fiscal year 2004.

Signatures

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

Applied Signal Technology, Inc.

/James E. Doyle/   June 8, 2004

James E. Doyle
Vice President and Chief Financial Officer
(Principal Financial and Accounting Officer)

Applied Signal Technology, Inc.
Index to Exhibits

3.1	Second Amended and Restated Articles of Incorporation
3.2	Amended and Restated Bylaws

4.1	Specimen Common Stock Certificate
10.26	Amendment to Line of Credit Agreement, dated February 12, 2004 with Wells Fargo Bank, National Association
10.27	Security Agreement dated February 12, 2004 with Wells Fargo Bank, National Association
10.28	Applied Signal Technology, Inc. 2004 Stock Incentive Plan
31.1	Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350, As Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2	Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, As Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002