APPLIED SIGNAL TECHNOLOGY INC
Form 10-Q
June 08, 2005

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 29, 2005

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 checkmark 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

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, 11,365,888 shares outstanding as of April 29, 2005.

Index
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 29, 2005 (Unaudited)	October 31, 2004 (Note)

Current assets:		
Cash and cash equivalents	$26,013	$ 11,227
Short term investments	25,654	32,615
	------------	------------
Total cash and cash equivalents and short-term investments	51,667	43,842
Accounts receivable:		
Billed	16,229	23,407
Unbilled	13,148	20,361
	------------	------------
Total accounts receivable	29,377	43,768
Inventory	10,617	5,392
Prepaid and other current assets	4,528	4,340
	------------	------------
Total current assets	96,189	97,342
Property and equipment, at cost:		
Machinery and equipment	49,425	47,545
Furniture and fixtures	4,922	4,855
Leasehold improvements	10,851	10,696
Construction in process	79	9
	------------	------------
	65,277	63,105
Accumulated depreciation and amortization	(52,367)	(50,682)
	------------	------------
Net property and equipment	12,910	12,423
Other assets	1,715	1,687
	------------	------------
Total assets	$110,814	$111,452
	========	========

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

Liabilities and Shareholders' Equity	April 29, 2005 (Unaudited)	October 31, 2004 (Note)
Current liabilities:		
Accounts payable	$3,650	$6,307
Accrued payroll and related benefits	10,115	12,012
Other accrued liabilities	2,350	2,336
Income taxes payable	320	28
	-----------	-----------
Total current liabilities	16,435	20,683
Long-term accrued rent	1,119	1,098
Other liabilities	333	305
Shareholders' equity:		
Common stock, no par value: 20,000,000 shares authorized; issued and outstanding: 11,365,888 at April 29, 2005 and 11,210,738 at October 31, 2004	39,979	37,943
Retained earnings	52,962	51,448
Accumulated comprehensive loss	(14)	(25)
	-----------	-----------
Total shareholders' equity	92,927	89,366
	-----------	-----------
Total liabilities and shareholders' equity	$110,814	$111,452
	========	========

Note: The balance sheet at October 31, 2004 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 29, 2005	April 30, 2004	April 29, 2005	April 30, 2004
Revenues from contracts	$32,053	$36,811	$62,163	$65,105

Operating expenses:				
Contract costs	20,646	24,146	40,485	42,446
Research and development	3,139	3,419	6,316	5,556
General and administrative	4,541	4,534	8,363	9,215
	-----------	-----------	-----------	-----------
Total operating expenses	28,326	32,099	55,164	57,217
	-----------	-----------	-----------	-----------
Operating income	3,727	4,712	6,999	7,888
Interest income, net	217	137	380	278
	-----------	-----------	-----------	-----------
Income before provision for income taxes	3,944	4,849	7,379	8,166
Provision for income taxes	1,617	912	3,025	2,073
	-----------	-----------	-----------	-----------
Net income	$2,327	$3,937	$4,354	$6,093
	=======	=======	=======	=======
Net income per common share:				
Basic	$0.20	$0.36	$0.38	$0.56
Diluted	$0.20	$0.34	$0.37	$0.53
Number of shares used in calculating net income per common share:				
Basic	11,364	10,990	11,329	10,922
Diluted	11,770	11,565	11,823	11,500

See Notes to Condensed Financial Statements.

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

	Six Months Ended	
	April 29, 2005	**April 30, 2004**

Operating Activities:		
Net income	$4,354	$6,093
Adjustments to reconcile net income to net cash provided by operating activities		
Depreciation and amortization	1,769	2,210
Changes in:		
Accounts receivable	14,391	(4,245)
Inventory, prepaids, and other assets	(5,441)	(400)
Accounts payable, taxes payable, and accrued expenses	(4,218)	5,564
Net cash provided by operating activities	10,855	9,222
Investing Activities:		
Purchases of available-for-sale securities	(18,945)	(24,781)
Maturities of available-for-sale securities	25,917	38,317
Additions to property and equipment	(2,256)	(1,903)
Net cash provided by investing activities	4,716	11,633
Financing Activities:		
Issuance of common stock	2,036	2,698
Dividends paid	(2,821)	(2,044)
Net cash provided (used) by financing activities	(785)	654
Net increase in cash and cash equivalents	14,786	21,509
Cash and cash equivalents, beginning of period	11,227	5,372
Cash and cash equivalents, end of period	$26,013	$26,881
Supplemental disclosures of cash flow information:		
Interest paid	$70	$75
Income taxes paid	$2,107	$359

See Notes to Condensed Financial Statements.

Applied Signal Technology, Inc.
Notes to Condensed Financial Statements
(Unaudited)

April 29, 2005

Note 1: Summary of Significant Accounting Policies

Description of Business and Basis of Presentation

Applied Signal Technology, Inc. provides advanced digital signal processing products, systems, and services used in collection and processing of signals for intelligence gathering, a process referred to as signal intelligence (SIGINT). Our fundamental business area within SIGINT is communications intelligence (COMINT) and more recently, we have been investing to expand into another portion of SIGINT, which is electronic intelligence (ELINT). COMINT derives intelligence from telecommunications signals, whereas ELINT derives intelligence from signals associated with weapons systems. 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, 2004. 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 29, 2005 are not necessarily indicative of the results that may be expected for the year ending October 31, 2005.

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 materially 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 by 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 (incurred costs). 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-reimbursement contracts. These subcontracts must be in excess of $250,000 and meet certain other predetermined criteria.

We recognize contract revenues and profits on cost-reimbursement contracts by applying an estimated fee rate to all incurred costs 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 upon contract completion.

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, or there are changes in facts and circumstances, we may be required to revise our estimates and 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 (incurred costs). 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 29, 2005	April 30, 2004	April 29, 2005	April 30, 2004
Cost-reimbursement contracts	80%	76%	79%	75%
Fixed-price contracts	20%	24%	21%	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 adjustments 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.

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-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, 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.

At April 29, 2005, the unfavorable rate variance was approximately $4,064,000 and at April 30, 2004 the favorable rate variance was $2,572,000.

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

When evaluating our need for a bad debt allowance, we consider our customer base and their payment history. The majority of our revenues are generated from the U.S. Government, and therefore credit risk is minimal. We record allowances for bad debt as a reduction to accounts receivable and an increase to bad debt expense. These allowances are recorded in the period a specific collection problem is identified. Once the receivable is deemed uncollectible, the allowance is reversed and the receivable is written off to bad debt expense.

At April 29, 2005 and October 31, 2004, there was no balance for the allowance for doubtful accounts. There was no charge to bad debt expense during the first six months of fiscal year 2005 or fiscal year 2004.

Income taxes. Our income tax expense at interim reporting periods is based on our estimated annual 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 such expected benefits as R&D credits and the reversals of valuation allowances. Please refer to “Notes to 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 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 year 2005 and 2004, 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.

Our securities are classified as available-for-sale and are carried at fair market value in short-term investments. 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 for the first six months of fiscal year 2005 and fiscal year 2004.

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

	April 29, 2005			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Market Value
Cash and cash equivalents	$26,013	$—	$—	$26,013
Short-term, available-for-sale securities:				
Asset-backed securities	3,561	—	(4)	3,557
Corporate securities	7,234	—	(6)	7,228
Government securities	7,905	—	(3)	7,902
Money market securities	6,968	—	(1)	6,967
	----------	----------	----------	----------
	$51,681	$—	($14)	$51,667
	=======	=======	=======	=======

	October 31, 2004			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Market Value
Cash and cash equivalents	$11,227	$—	$—	$11,227
Short-term, available-for-sale securities:				
Asset-backed securities	3,521	—	(15)	3,506

Corporate securities	2,619	—	(3)	2,616
Government securities	4,002	—	(4)	3,998
Money market securities	22,498 ----------	— ----------	(3) ----------	22,495 ----------
	$43,867 =======	$— =======	($25) =======	$43,842 =======

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

	April 29, 2005	October 31, 2004
Due in one year or less	$23,688	$32,615
Due in one to three years	1,966 ----------	— ----------
	$25,654 =======	$32,615 =======

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 29, 2005	April 30, 2004	April 29, 2005	April 30, 2004
Numerator:				
Net income	$2,327 =======	$3,937 =======	$4,354 =======	$6,093 =======
Denominator:				
Shares used to compute net income per common share – basic	11,364	10,990	11,329	10,922
Effect of dilutive stock options	406 -----------	575 -----------	494 -----------	578 -----------
Shares used to compute net income per common share – diluted	11,770 =======	11,565 =======	11,823 =======	11,500 =======
Net income per common share – basic	$0.20	$0.36	$0.38	$0.56
Net income per common share – diluted	$0.20	$0.34	$0.37	$0.53

The exercise price for approximately 408,000 and 120,000 of potential common shares for the three-month and six-month periods ending April 29, 2005 was greater than the market value, and therefore we excluded those shares from the diluted net income per common share computation for the second quarter and first six months of fiscal year 2005. For the same periods in fiscal year 2004, we excluded 5,000 and 50,000 potential common shares from the diluted net income per common share computation for the same reason as the second quarter and first six months of fiscal year 2005.

Comprehensive Income

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

	Three Months Ended		Six Months Ended	
	April 29, 2005	April 30, 2004	April 29, 2005	April 30, 2004
Net income	$2,327	$3,937	$4,354	$6,093
Unrealized gain (loss) on securities	11	(73)	11	(71)
Comprehensive income	$2,338	$3,864	$4,365	$6,022

As of April 29, 2005, accumulated unrealized loss on securities was approximately $14,000. As of October 31, 2004, accumulated unrealized loss on securities was approximately $25,000.

Dividends

In November 2004, the Board of Directors approved the continuation of the dividend at the rate of $0.50 per share per annum, payable quarterly. Dividends were paid on February 11, 2005 and May 13, 2005, and are payable on August 12, 2005 and November 11, 2005 to shareholders of record at January 28, 2005, April 29, 2005, July 29, 2005, and October 31, 2005, respectively.

We paid dividends of approximately $2,821,000 during the first six months of fiscal year 2005 and approximately $2,044,000 during the first six months of fiscal year 2004.

At April 29, 2005 and October 31, 2004, accrued dividends of approximately $1,420,000 and $1,401,000, respectively, were included in other accrued liabilities on 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 29, 2005	April 30, 2004	April 29, 2005	April 30, 2004
Net income, as reported	$2,327	$3,937	$4,354	$6,093
Deduct: total stock-based compensation expense determined at the fair value for all awards, net of related tax effects	(835)	(584)	(1,673)	(1,081)
Pro forma net income	$1,492	$3,353	$2,681	$5,012
Net income per share				

Basic – As reported	$0.20	$0.36	$0.38	$0.56
– Pro forma	$0.13	$0.31	$0.24	$0.46
Diluted – As reported	$0.20	$0.34	$0.37	$0.53
– Pro forma	$0.13	$0.29	$0.23	$0.44

The fair value of options at the date of grant was estimated by using the Black-Scholes valuation model with the following weighted average assumptions:

	Employee Stock Options		Employee Stock Purchase Plan	
	Six Months Ended April 29, 2005	Six Months Ended April 30, 2004	Six Months Ended April 29, 2005	Six Months Ended April 30, 2004
Risk-free interest rate	3.8%	3.6%	2.8%	1.0%
Expected life (years)	5	5	0.5	0.5
Expected volatility	2.68	1.60	2.68	1.61
Expected dividends	1.3%	1.7%	1.3%	1.8%

Recent Accounting Pronouncements

In December 2004, the FASB issued Statement of Financial Accounting Standard No. 123R, *Share-Based Payment*, or SFAS 123R. SFAS 123R replaces SFAS 123. The statement requires that the costs resulting from share-based payment transactions be recognized in the financial statements. The statement requires companies to use the fair-value-based payment measurement method in accounting for share-based payment with employees as well as for goods and services received from non-employees. SFAS 123R is effective for all awards granted after the first annual reporting period that begins after June 15, 2005 with early adoption permitted. We have no plans for early adoption and therefore SFAS 123R will be effective beginning with our quarter ending January 27, 2006.

The effects of the adoption of SFAS No. 123R on our results of operations and financial position are dependent upon a number of factors, including the number of employee stock options outstanding and unvested, the number of employee options that may be granted in the future, the future market value and volatility of our stock price, movements in the risk-free rate of interest, stock option exercise and forfeiture patterns, and the stock option valuation model used to estimate the fair value of each option. As a result of these variables, it is not yet possible to reliably estimate the effect of the adoption of SFAS No. 123R on our results of operations and financial position, however, we expect that the adoption of SFAS 123R will have a material impact on our results of operations and earnings per share. Note 1 herein provides an indication of the effects of adoption assuming the use of the Black-Scholes option pricing model to estimate the fair value of employee stock options and employee stock purchase plan awards upon the results of operations for the three months and six months ended April 29, 2005 and April 30, 2004. We, however, have not determined whether the adoption will result in amounts that are similar to the current pro forma disclosures under SFAS No. 123.

Note 2: Inventory

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

	April 29, 2005	October 31, 2004
Raw materials	$610	$719
Work in process	9,735	4,428
Finished goods	157 ----------	222 ----------
	10,502	5,369

Precontract costs	115	23
	---------	---------
	$10,617	$5,392
	=======	=======

At April 29, 2005, the unfavorable inventoried indirect rate variance increased work in process by approximately $4,064,000. At April 30, 2004, the favorable inventoried indirect rate variance decreased work in process by approximately $2,572,000.

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.

Inventory activities during the first six months of fiscal year 2005 and 2004 included $150,000 and $1,000,000 of disposals of obsolete products, respectively. The disposed items consisted of units in various stages of completion.

Note 3: Line of Credit

At April 29, 2005, we had a cash-secured line of credit with a bank in the amount of $3,000,000. Borrowings under the line of credit bear interest at the bank's reference rate (5.75% at April 29, 2005) and accrued interest on those borrowings were payable monthly**.** No fees were associated with the unused portion of the committed amount. This line of credit will expire on March 1, 2006.

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 29, 2005 and October 31, 2004. The second letter of credit was a requirement of our workers compensation insurance, and was approximately $150,000 at April 29, 2005 and October 31, 2004. At both April 29, 2005 and October 31, 2004, we had 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 second quarter and first six months of fiscal years 2005 and 2004.

Note 5: Provision for Income Taxes

Our provision for income taxes for the second quarter and first six months of fiscal year 2005 was approximately $1,617,000 and $3,025,000, respectively, with an estimated annual effective tax rate of 41%. Our provision for income taxes for the same periods of fiscal year 2004 was approximately $912,000 and $2,073,000, respectively. Our provision for income taxes for the first six months of fiscal year 2004 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. Our estimated annual effective tax rate at April 29, 2005 differed from our effective tax rate at April 30, 2004 due to our return to a full tax rate.

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 percentage of the purchase price. An additional six-month warranty may be purchased for 3% of the unit or system purchase price. Additional one-year warranty coverage is 5% of the unit or system purchase price. Warranty costs in the second quarter and first six months of fiscal year 2005 were approximately $110,000 and $140,000, respectively. Fiscal year 2004 warranty costs were approximately $31,000 and $72,000 for the second quarter and first six months of fiscal year 2004, respectively.

***Legal proceedings*.** On March 11 and April 19, 2005, purported securities class action complaints were filed in the United States District Court, Northern District of California: Berson v. Applied Signal Technology Inc., No. 4:05-cv-1027 (SBA) (N.D. Cal.) and Sameyah v. Applied Signal Technology Inc., No.4:05-cv-1615 (SBA) (N.D. Cal.). The complaints, which are substantially identical, are brought on behalf of a putative class of persons who purchased the Company's securities during a class period of May 25, 2004 through February 22, 2005. The complaints name the Company, its Chief Executive Officer, and its Chief Financial Officer as defendants, and allege that false and misleading statements regarding the Company were issued during the class period. A putative class member has moved for appointment as lead plaintiff, and the litigation is in the preliminary stage. We believe that there are meritorious defenses against this litigation and intend to vigorously defend it. However, due to the inherent uncertainties of litigation, we cannot accurately predict the ultimate outcome of the litigation. Any unfavorable outcome of the litigation could have an adverse impact on our business, financial condition, and results of operation.

Note 7: Contractual Obligations

The following table sets forth our contractual obligations as of April 29, 2005 (in thousands):

	Payments Due by Period				
	Total	Less than 1 year	1–3 years	3–5 years	More than 5 years
Operating Lease Obligations	$29,224	$4,553	$9,199	$8,702	$6,770
Purchase Obligations	1,503	1,503	—	—	—
	----------	----------	----------	----------	----------
Total	$30,727	$6,056	$9,199	$8,702	$6,770
	=======	=======	=======	=======	=======

Our operating lease obligations consist of non-cancelable lease agreements for our facilities, which expire at various dates between fiscal years 2005 and 2012. Certain leases contain escalation clauses and requirements for the payment of property taxes, insurance, and maintenance expenses.

During the first six months of fiscal year 2005, we entered into a new lease agreement for our Texas office.

Note 8: Subsequent Event

On May 23, 2005, we entered into an agreement to acquire Dynamics Technology, Inc. (“DTI”), a privately-held company headquartered in Torrance, California with offices in Anaheim, California and Arlington, Virginia. DTI is a provider of advanced sensor and signal processing solutions for advanced space-based, airborne, terrestrial, and undersea sensor technologies. The combined company will be a provider of signal processing products and services in support of intelligence, surveillance, and reconnaissance for global security; processing products for synthetic aperture sonar; and radar solutions. The definitive agreement provides for the merger of DTI with a wholly-owned subsidiary of Applied Signal Technology, Inc. in exchange for the payment by Applied Signal Technology, Inc. to the holders of DTI common stock of the sum of $30 million in cash subject to an adjustment based upon the closing balance sheet of DTI, plus all cash received by DTI prior to the closing from the exercise of options to acquire DTI common stock. We will fund the consideration from our current investments and from a term loan that we expect to enter into with Wells Fargo Bank, National Association, in the principal amount of $10 million. Consummation of the acquisition, expected to close on or about July 1, 2005, is subject to reciprocal closing conditions, including approval from the DTI shareholders, absence of governmental restraints, and accuracy of representations. The definitive agreement contains certain termination rights for both Applied Signal Technology, Inc. and DTI. Ten percent (10%) of the purchase price will be deposited into an escrow account for twelve (12) months following the closing to satisfy certain indemnification obligations of the DTI shareholders.

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, 2004.

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 collection and processing of signals for intelligence gathering, a process referred to as signal intelligence (SIGINT). Our fundamental business area within SIGINT is communications intelligence (COMINT) and more recently, we have been investing to expand into another portion of SIGINT, which is electronic intelligence (ELINT). COMINT derives intelligence from telecommunications signals, whereas ELINT derives intelligence from signals associated with weapons systems. Our primary customer is the United States Government. We develop and manufacture equipment for both the collection and processing of signals.

Our COMINT 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 COMINT 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 COMINT processing equipment. Over time, we have broadened our scope to add specialized collection equipment and complete signal processing systems, and related services.

Our investment in ELINT is directed toward the development of equipment for the collection and processing of weapons systems signals. These equipments will be able to scan the radar bands associated with weapons systems and determine the type of system and its precise location for battlefield characterization and force protection. The equipment will also analyze the command and control signals associated with these weapons systems to provide information about battlefield readiness.

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 materially 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 “Notes to Condensed Financial Statements, Note 1: Summary of Significant Accounting Policies,” 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 by 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 (incurred costs). 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-reimbursement 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 incurred costs 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 upon contract completion.

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. Historically, management’s estimates have generally been consistent with actual fees awarded. However, changes could arise causing management to either lower or raise the award fee estimate in the period in which the change is identified.

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 (incurred costs). 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.

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 materially 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.

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

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 believe 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.

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, anticipated performance on specific contracts, and anticipated changes in inventory.

At April 29, 2005, the unfavorable inventoried indirect rate variance was approximately $4,064,000. At April 30, 2004, the favorable inventoried rate variance was approximately $2,572,000.

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 such expected benefits as R&D credits and the reversals of valuation allowances.

Allowance for bad debt. Since the majority of our revenues are generated from the U.S. Government, we regard the credit risk of our business to be minimal. We record allowances for bad debt as a reduction to accounts receivable and an increase to bad debt expense. These allowances are recorded in the period a specific collection problem is identified. Once the receivable is deemed uncollectible, the allowance is reversed and the receivable is written off.

At April 29, 2005 and October 31, 2004, there was no balance for the allowance for doubtful accounts. There was no charge to bad debt expense during the second quarter and first six months of fiscal year 2005 or fiscal year 2004.

Inventory valuation and disposal. We provide advanced digital signal processing products and systems to the U.S. Government. Typical life cycles of our equipment 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 our equipment, which includes raw materials. Historically, we have sold our inventory at full cost so there is limited decrement in valuation. If it is determined that a product has reached the end of its life cycle or there is no longer a need for certain equipment, the remaining inventory is disposed. Historically, we dispose of inventory at approximately the same time that the reduction to inventory 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. Disposed raw material represents a minor amount 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.

We disposed of approximately $150,000 of inventory during the first six months of fiscal year 2005. During the same period of fiscal year 2004 we disposed of approximately $1,000,000 of obsolete products. The disposed items included units in various stages of completion.

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 2005 and 2004, we did not incur any price redeterminations on any of our contracts.

Overview

Although revenue growth has slowed during the first six months ended April 29, 2005, we believe that there continues to be an interest in signal intelligence by the U.S. Government to respond to the threat of terrorist activities and the war against terrorism, and that we are well positioned to benefit from the spending that might result. We believe that our core COMINT business continues to have strong growth potential and that our move into the ELINT business provides us an opportunity to diversify into a complementary business. As a result of this diversification, we expect to make additional investments of capital and management resources, including additional personnel and facilities. We are investing research and development into developing ELINT collection and processing equipments, and expect to continue to grow this business during the coming quarters.

On May 23, 2005, we entered into agreement to acquire Dynamics Technology, Inc. (“DTI”), a privately-held company headquartered in Torrance, California with offices in Anaheim, California and Arlington, Virginia. DTI is a provider of advanced sensor and signal processing solutions for advanced space-based, airborne, terrestrial, and undersea sensor technologies. The combined company will be a provider of signal processing products and services in support of intelligence, surveillance, and reconnaissance for global security; processing products for synthetic aperture sonar; and radar solutions. The definitive agreement provides for the merger of DTI with a wholly-owned subsidiary of Applied Signal Technology, Inc. in exchange for the payment by Applied Signal Technology, Inc. to the holders of DTI common stock of the sum of $30 million in cash subject to an adjustment based upon the closing balance sheet of DTI, plus all cash received by DTI prior to the closing from the exercise of options to acquire DTI common stock. We will fund the consideration from our current investments and from a term loan that we expect to enter into with Wells Fargo Bank, National Association, in the principal amount of $10 million. Consummation of the acquisition, expected to close on or about July 1, 2005, is subject to reciprocal closing conditions, including approval from the DTI shareholders, absence of governmental restraints, and accuracy of representations. The definitive agreement contains certain termination rights for both Applied Signal Technology, Inc. and DTI. Ten percent (10%) of the purchase price will be deposited into an escrow account for twelve (12) months following the closing to satisfy certain indemnification obligations of the DTI shareholders.

We continue to focus our operations on assuring program performance, meeting staffing requirements, maintaining a competitive cost structure, and diversifying our marketplace. While our customers continue to come to us with new requirements for intelligence solutions, weighted heavily toward new developments, we have experienced strong proposal activity in the current quarter. As a result, we have faced challenges meeting the execution requirements of the contracts in backlog and continue to emphasize increased hiring in order to meet all of our program commitments. A significant portion of our revenue continues to be generated by cost-reimbursable contracts that 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 2005.

Three and Six Months Ended April 29, 2005 Compared to Three and Six Months Ended April 30, 2004

Revenues and backlog. Revenues for the second quarter of fiscal year 2005 were approximately $32,053,000, a 12.9% decrease from revenues of approximately $36,811,000 recorded in the same quarter of fiscal year 2004. Revenues for the first six months of fiscal year of 2005 were approximately $62,163,000, a 4.5% decrease from revenues of approximately $65,105,000 recognized during the same period of fiscal year 2004. The decrease in revenues recorded during the second quarter and the first six months of fiscal year 2005, when compared to the same period in fiscal year 2004, is primarily due to less product sales and a reduction in revenues from our largest contract. We believe the reduction in revenues from our largest contract was primarily a result of the stop work notice we received on a portion of this contract during fiscal year 2004.

New orders received during the second quarter and first six months of fiscal year 2005 were approximately $21,284,000 and $32,410,000, down 25.7% and 65.2% from approximately $28,636,000 and $93,185,000 in new orders received during the same periods in fiscal year 2004. The level of new orders for the first six months of fiscal year 2004 were significantly higher than the same period in fiscal year 2005 as a result of a major modification resulting in an increase to our largest contract of approximately $48,524,000 received during the first quarter of fiscal year 2004.

Our backlog consists of the uncompleted portions of existing contracts (excluding unexercised contract options). At April 29, 2005, ending backlog was approximately $113,616,000, representing a 20.8% decrease from ending backlog of approximately $143,369,000 at October 31, 2004.It should be noted that new orders and backlog are expected to be reduced by approximately $ 11 to $13 million when we complete negotiations of a stop-work order related to a portion of our largest contract. These negotiations will clarify the scope of the stop-work order. We anticipate the completion of these negotiations during fiscal year 2005. We estimate that our opportunity to generate revenues from this contract was reduced by approximately $3 to $4 million in fiscal year 2004, and will be reduced by approximately $6 to $7 million in fiscal year 2005 and the balance in fiscal year 2006.

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 our revenue concentration during the respective periods by contract type:

	Three Months Ended		Six Months Ended		Twelve Months Ended
	April 29, 2005	April 30, 2004	April 29, 2005	April 30, 2004	October 31, 2004
Cost-reimbursement contracts	80%	76%	79%	75%	74%
Fixed-price contracts	20%	24%	21%	25%	26%

Three contracts represented 42.9% and 44.8% of revenues during the second quarter and first six months of fiscal year 2005, respectively, and 35.7% and 36.9% of revenues during the same periods of fiscal year 2004, respectively. First, our largest contract represented 12.7% and 13.3% of revenues for the second quarter and first six months of fiscal year 2005, respectively. For the second quarter and first six months of fiscal year 2004, our single largest contract represented 21% of revenues. Second, an indefinite delivery/indefinite quantity contract includes a number of related delivery orders and represented approximately 17.7% and 19.9% of revenues for the second quarter and first six months of fiscal year 2005, respectively. This contract represented approximately 13.7% and 15.3% of revenues for the second quarter and first six months of fiscal year 2004, respectively. Third, another significant indefinite delivery/indefinite quantity contract is approximately 12.5% and 11.6% of revenue for the second quarter and first six months of fiscal year 2005. However this contract only represented 1.0% and 0.6% for the same periods in fiscal year 2004.

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 $20,646,000, or 64.4% of revenues, for the second quarter of fiscal year 2005 compared to approximately $24,146,000, or 65.6% of revenues, for the same period of fiscal year 2004. Contract costs were approximately $40,485,000, or 65.1% of revenues, for the first six months of fiscal year 2005 compared to approximately $42,446,000, or 65.2%, of revenues for the same period of fiscal year 2004. Contract costs decreased in absolute dollars during the second quarter and first six months of fiscal year 2005 compared to the same periods of 2004 due to the decrease in revenues and reduction in scrap activities from inventory. As a percentage of revenues, contract costs were not significantly different between the second quarter and first six months of fiscal year 2005 and the same periods of fiscal year 2004, and were within historical levels. We anticipate that contract costs, as a percentage of revenues, for fiscal year 2005 will be similar to the first six months of fiscal year 2005.

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 $3,139,000, or 9.8% of revenues, for the second quarter of fiscal year 2005 compared to approximately $3,419,000, or 9.3% of revenues , for the same period of fiscal year 2004. During the first six months of fiscal year 2005, R&D expenses were approximately $6,316,000, or 10.2% of revenues, compared to approximately $5,556,000, or 8.5% of revenues, incurred during the first six months of fiscal year 2004. R&D expenses were lower in absolute dollars during the second quarter of fiscal year 2005 compared to the second quarter of fiscal year 2004 as a result of the use of annual targeted indirect rates at interim reporting periods. R&D expenses were lower in absolute dollars and as a percentage of revenue during the first six months of fiscal year 2004 due to the staffing requirements on our contracts. These requirements caused management to delay focus on R&D efforts in order to meet out contractual commitments. We anticipate that R&D expenses, as a percentage of revenues, for fiscal year 2005 will be similar to the first six months of fiscal year 2005.

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 our quarterly revenue base, for interim reporting periods. General and administrative expenses were approximately $4,541,000, or 14.2% of revenues, for the second quarter of fiscal year 2005 compared to approximately $4,534,000, or 12.3% of revenues, for the same period of fiscal year 2004. General and administrative expenses incurred during the first six months of fiscal year 2005 were approximately $8,363,000, or 13.5% of revenues, compared to approximately $9,215,000, or 14.2%, of revenues, incurred during the same period of fiscal year 2004. General and administrative expenses were higher as a percentage of revenues during the second quarter of fiscal year

2005 as compared to the second quarter of fiscal year 2004 due to the decrease in revenues during the second quarter of fiscal year 2005. However, general and administrative expenses were lower for the first six months of fiscal year 2005 as compared to the same period of fiscal year 2004 as a result of the use of lower annual targeted indirect rates at interim reporting periods. We anticipate that general and administrative expenses, as a percentage of revenues, for fiscal year 2005 will be similar to the first six months of fiscal year 2005. However, general and administrative expenses could be greater in absolute dollars for fiscal year 2005 than 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 at 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 may be purchased for 5% of the unit or system purchase price. Warranty costs were approximately $110,000 and $140,000 for the second quarter and first six months of fiscal year 2005, respectively. Warranty costs were approximately $31,000 and $72,000 during the second quarter and first six months of fiscal year 2004. We have not noticed any significant trends associated with our warranty costs. Additionally, the warranty costs for fiscal year 2005 are within historical levels.

Interest income (expense), net. Net interest income for the second quarter of fiscal year 2005 was approximately $217,000 compared to net interest income of approximately $137,000 for the second quarter of fiscal year 2004. Net interest income recognized during the first six months of fiscal year 2005 was approximately $380,000 compared to net interest income of approximately $278,000 during the first six months of fiscal year 2004. Interest income increased during the second quarter of fiscal year 2005 as a result of higher combined cash and investment balances during the second quarter and in the first six months of fiscal year 2005 when compared to the same periods of fiscal year 2004.

Provision for income taxes. Our provision for income taxes for the first six months of fiscal year 2005 was approximately $3,025,000, representing a 41% effective tax rate. 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. Our estimated annual effective tax rate at April 29, 2005 differed from our effective tax rate at April 30, 2004 due to our return to a full tax rate.

Analysis of Liquidity and Capital Resources

Our primary sources of liquidity during the first six months of fiscal year 2005 were cash flows generated from operations and the issuance of common stock through exercise of options granted under our employee stock option plans and stock purchases under our employee stock purchase plan.

Net cash from operating activities. Net cash from 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 cash of approximately $10,855,000and approximately $9,222,000 during the first six months of fiscal years 2005 and 2004, respectively. Net income for the first six months of fiscal year 2005 was approximately $4,354,000 compared to a net income of approximately $6,093,000 for the comparable period of fiscal year 2004. The decrease in net income is due, in part, to a reduction to our revenues and, in part, to an increase in our effective tax rate in fiscal year 2005 when compared to fiscal year 2004.

Accounts receivable balances decreased during the first six months of fiscal year 2005 by approximately $14,391,000, and increased by approximately $4,245,000 in the same period of fiscal year 2004. The difference between the first six months of fiscal year 2005 and fiscal year 2004 is due to a significant increase in accounts receivable collection activities during the first six months of fiscal year 2005.

Cash used to support inventory, prepaid expenses, and other assets was approximately $5,441,000 and $400,000 during the first six months of fiscal years 2005 and 2004, respectively. The fluctuation in cash used between the first six months of fiscal year 2005 and the first six months of fiscal year 2004 is primarily due to the difference in the indirect rate variance between those two periods.In the first six months of fiscal year 2005, the unfavorable indirect rate variance increased inventory balances by approximately $4,064,000**.** During the same period of fiscal year 2004, the favorable indirect rate variance decreased inventory balances by approximately $2,572,000.

The change in accounts payable, taxes payable, and accrued liabilities balances resulted in a net decrease of approximately $4,218,000 during the first six months of fiscal years 2005 and a net increase of approximately $5,564,000 in the same period of fiscal year 2004. Accrued payroll liabilities decreased approximately $1,897,000 during the first six months of fiscal year 2005, and increased approximately $1,009,000during the same period of fiscal year 2004. The difference between accrued payroll liabilities is attributable to the increase in bonuses paid during the first six months of fiscal year 2005 as compared to the first six months of fiscal year 2004. Accounts payable and other accrued liabilities decreased approximately $2,613,000 during the first six months of fiscal years 2005 and increased approximately $1,974,000 the same period in fiscal year 2004. The differences between accounts payable activities during the first six months of fiscal years 2005 and 2004 are due to payments for contract costs in the beginning of fiscal year 2005 accrued at the end of fiscal year 2004 and an overall decline in materials purchases during the first six months of fiscal year 2005.

Net cash from investing activities. Investing activities provided cash of approximately $4,716,000 and $11,633,000 during the first six months of fiscal years 2005 and 2004, respectively. The primary difference between the first six months of fiscal years 2005 and 2004 was due to significant proceeds received from the sale of short term investments during the first six months of fiscal year 2004, from the adoption of an investment policy with a shorter average maturity date.

Net cash from financing activities. Financing activities used cash of approximately $785,000 during the first six months of fiscal year 2005 and provided cash of approximately $654,000 during the same period in fiscal year 2004. The primary differences in financing activities between the first six months of fiscal years 2005 and 2004 is the increase in the amount of dividends paid during the first six months of fiscal year 2005 when compared to fiscal year 2004, and the decrease in stock option being exercised.

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 intelligence needs of the U.S. Government.

In the third quarter of fiscal year 2005, the Board of Directors approved the change of our investment policy to adopt tax-exempt securities. The company is in transition to adopt the revised investment policy and will assess the benefits of tax savings in the future quarters.

At April 29, 2005, we had a cash-secured line of credit with a bank in the amount of $3,000,000. Borrowings under the line of credit bear interest at the bank’s reference rate (5.75% at April 29, 2005) and accrued interest on those borrowings were payable monthly. No fees were associated with the unused portion of the committed amount. This line of credit will expire on March 1, 2006.

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 29, 2005 and October 31, 2004, respectively. The second letter of credit was a requirement of our workers compensation insurance, and was approximately $150,000. At both April 29, 2005 and October 31, 2004, there were no other borrowings.

In addition, we expect to fund the acquisition of DTI, which is planned to close on or about July 1, 2005, from our current investments and from a term loan that we expect to enter into with Wells Fargo Bank, National Association, in the principal amount of $10 million.

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

Contractual Obligations

The following table sets forth our contractual obligations as of April 29, 2005 (in thousands).

	Payments Due by Period				
	Total	Less than 1 year	1–3 years	3–5 years	More than 5 years
Operating Lease Obligations	$29,224	$4,553	$9,199	$8,702	$6,770
Purchase Obligations	1,503	1,503	—	—	—
	----------	----------	----------	----------	----------
Total	$30,727	$6,056	$9,199	$8,702	$6,770
	=======	=======	=======	=======	=======

Our operating lease obligations consist of non-cancelable lease agreements for our facilities, which expire at various dates between fiscal years 2005 and 2012. Certain leases contain escalation clauses and requirements for the payment of property taxes, insurance, and maintenance expenses.

During the first six months of fiscal year 2005, we entered into a new lease agreement for our Texas office.

Recent Accounting Pronouncements

In December 2004, the FASB issued Statement of Financial Accounting Standard No. 123R, *Share-Based Payment*, or SFAS 123R. SFAS 123R replaces SFAS 123. The statement requires that the costs resulting from share-based payment transactions be recognized in the financial statements. The statement requires companies to use the fair-value-based payment measurement method in accounting for share-based payment with employees as well as for goods and services received from non-employees. SFAS 123R is effective for all awards granted after the first interim or annual reporting period that begins after June 15, 2005 with early adoption permitted. We have no plans for early adoption and therefore SFAS 123R will be effective for our fiscal year 2006 first quarter ending January 27, 2006.

The effects of the adoption of SFAS No. 123R on our results of operations and financial position are dependent upon a number of factors, including the number of employee stock options outstanding and unvested, the number of employee options that may be granted in the future, the future market value and volatility of our stock price, movements in the risk-free rate of interest, stock option exercise and forfeiture patterns, and the stock option valuation model used to estimate the fair value of each option. As a result of these variables, it is not yet possible to reliably estimate the effect of the adoption of SFAS No. 123R on our results of operations and financial position, however, we expect that the adoption of SFAS 123R will have a material impact on our results of operations and earnings per share. Note 1 of the *Notes to Condensed Financial Statements* provides an indication of the effects of adoption assuming the use of the Black-Scholes option pricing model to estimate the fair value of employee stock options and employee stock purchase plan awards upon the results of operations for the six months ended April 29, 2005 and April 30, 2004. We, however, have not determined whether the adoption will result in amounts that are similar to the current pro forma disclosures under SFAS No. 123.

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 occurs, 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.

We are subject to a number of special risks as a result of our planned acquisition of Dynamics Technology, Inc. On May 23, 2005, we entered into an agreement to acquire Dynamics Technology, Inc. (“DTI”) for $30 million. The acquisition is subject to a number of conditions, and there is no assurance that the acquisition will be completed. If the conditions to closing are satisfied and the acquisition is consummated, our future results of operation will be substantially influenced by the operations of the new business unit, and we will be subject to a number of risks and uncertainties, including the following:

- We will face a number of significant challenges in integrating the technologies, operations, and personnel of DTI in a timely and efficient manner, and our failure to do so effectively could have a material, adverse effect on our business and operating results. We also face risks associated with entering markets in which Applied Signal Technology, Inc. has no or limited prior experience.
- We may not achieve the strategic objectives and other anticipated potential benefits of the acquisition, and our failure to achieve these strategic objectives could have a material, adverse effect on our revenues, expenses, and operating results.
- Transaction costs associated with the acquisition will be included as part of the total purchase cost for accounting purposes. In addition, we may incur charges to operations in amounts that are not currently estimable, in the quarter in which the acquisition is completed or in following quarters, to reflect costs associated with integrating the two companies. In addition, we will record additional operating expenses associated with the amortization of other intangible assets. These costs could adversely affect our future liquidity and operating results.
- Customers of DTI may have a right to terminate certain agreements with DTI as a result of the acquisition, and we may be unable to retain all existing, or enter into new, contracts for DTI’s business lines after the merger is completed.
- Both companies have as its largest customer the U.S. Government and civilian and military agencies of the U.S. Government. The contracts entered into by both companies with the U.S. Government are terminable by the U.S. Government. We face risks associated with integrating the contracting activities of the combined company, and there can be no assurance that the U.S. Government will maintain existing, or enter into new contracts with the combined company. It is possible that, as a result of the acquisition, our customers may delay or defer contracting decisions, which could have a material, adverse effect on our business.
- As a result of the acquisition, we expect to incur debt in the amount of $10 million, and our failure to repay this debt when due would materially, adversely affect our financial condition and results of operations.
- As a result of the acquisition, Applied Signal Technology, Inc. will become a larger, more geographically dispersed and complex organization, and if our management is unable to effectively manage the combined company after the acquisition, our operating results will suffer.
- The acquisition will increase the cost and complexity of complying with the requirements of Section 404 of the Sarbanes-Oxley Act of 2002 with regard to the evaluation and attestation of our internal control systems and may increase the risks of achieving timely compliance.
- We may also be assuming unknown liabilities; risk the incurrence of expenses related to the future impairment of goodwill; or the incurrence of other large write-offs immediately or in the future.
- Whether or not the merger is completed, the announcement of the proposed merger may cause disruptions in our business, which could adversely affect our business and operations.
- Achieving the benefits of the merger, however, will depend on many factors, including the successful and timely integration of the two companies following the completion of the merger. These integration efforts may be difficult and time consuming, especially considering the highly technical and complex nature of each company’s products. Integration efforts between the two companies will also divert significant management attention and resources. This diversion of attention and resources could have an adverse effect on

Any decrease in expected product sales during a period could adversely impact our revenues, results of operations, and financial condition. From time to time, we have derived a significant portion of our revenue from product sales. In recent periods, however, we have been focusing on sales of systems and software, and targeting larger programs. In addition, we have experienced some seasonality in product sales to the U.S. Government, with more product sales occurring in the second half of the fiscal year than the first. The amount and timing of Government purchases of products is unpredictable, and fluctuates significantly from period to period, making it difficult for us to predict the amount of revenue we will generate from product sales in any particular period, and causing our revenues to fluctuate from period to period. If we are not able to generate revenues from product sales as expected in a particular period, we may fail to meet our revenue expectations and the expectations of industry analysts and investors, which could cause our stock price to decline.

Any reduction in government spending on signal intelligence could adversely impact our revenues, results of operations, and financial condition materially. 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 materially 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 these 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, U.S. 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 it prevails, 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 could significantly decline. Our success will depend on our continued ability to develop and manage relationships with significant customers. 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 continue to 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 U.S. Government security clearances in order to perform tasks required 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 could have a material 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. There were no such notifications in fiscal years 2005 or 2004.

Stop-work orders could negatively impact our operating results and financial condition. Almost all of our contracts contain stop-work clauses that permit the other contracting party, at any time, by written order, to stop work on all or any part of the work called for by the contract for a period of ninety days. Within the ninety-day period, the other contracting party may cancel the stop-work order and resume work or terminate all or part of the work covered by the stop-work order. During June 2004, we received a stop-work order instructing us to stop work on a portion of our largest single contract. In accordance with the instructions received from the other contracting party, we prepared a proposal that detailed the tasks that were stopped and estimated the reduction in contract costs. We expect new orders and backlog to be reduced by approximately $11 to $13 million when we complete negotiations. We anticipate that these negotiations, which will clarify the scope of the stop-work order, will be completed during fiscal year 2005. We estimate that our opportunity to generate revenues from this contract was reduced by approximately $3 to $4 million in fiscal year 2004, and will be reduced by approximately $6 to $7 million in fiscal year 2005 and the balance in fiscal year 2006. There can be no assurance that stop-work orders will not be received in future periods.

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 earnings 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, or on a timely basis, if at all. 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 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 materially 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, six 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.

Standards for compliance with Section 404 of the Sarbanes-Oxley Act of 2002 are uncertain, and if we fail to comply in a timely manner, our business could be harmed and our stock price could decline. Rules adopted by the Securities and Exchange Commission pursuant to Section 404 of the Sarbanes-Oxley Act of 2002 require annual assessment of our internal control over financial reporting, and attestation of our assessment by our independent registered public accountants. This requirement will first apply to our Annual Report on Form 10-K of the fiscal year ending October 31, 2005. The rules governing the standards that must be met for management to assess the internal control over financial reporting as effective are new and complex, and require significant documentation, testing, and possible remediation of our internal controls to meet the detailed standards under these new rules. We may encounter problems or delays in completing activities necessary to make an assessment that our internal control over financial reporting is effective. In addition, the attestation process by our independent registered public accountants is new and we may encounter problems or delays in completing the implementation of any requested improvements and receiving an attestation of our assessment by our independent registered public accountants. If we cannot assess our internal controls as effective or our independent registered public accountants are unable to provide an unqualified attestation report on such assessment of our internal control over financial reporting, investor confidence and share value may be negatively impacted.

In addition, we expect to incur additional operating expenses as we implement Section 404 of the Sarbanes-Oxley Act.

We may not achieve the anticipated benefits of our investments in new business opportunities and any such investments could have a negative, material impact on our operating results and financial condition. We have formed the Electronic Systems Division in order to expand our historical SIGINT business into ELINT. This diversification requires us to invest additional capital, open new facilities, and incur additional R&D expenditures. In addition, diversification results in diversion of management's attention from our core business. Although we believe that entering into these new business areas will be important to remaining competitive in the defense electronics marketplace, there can be no assurance that we will derive benefits from this diversification and we could incur significant unanticipated costs, which could have a material impact on our results of operations.

Item 3: Quantitative and Qualitative Disclosures About Market Risk

Interest rate risk. Our interest income is sensitive to changes in the general level of U.S. interest rates, particularly since the majority of our investments are in short-term instruments. The average maturity of our investment portfolio is 76 days as of April 29, 2005. 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 29, 2005, our total cash and investment balance that was sensitive to interest rate risk was approximately $51,667,000. 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 $102,000.

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 29, 2005	October 31, 2004
Cash and cash equivalents	$26,013	$11,227
Short-term, available-for-sale securities:		
Asset-backed securities	3,557	3,506
Corporate securities	7,228	2, 616
Government securities	7,902	3, 998
Money market securities	6,967 -----------	22,495 -----------
	$51,667 =======	$43, 842 =======

Item 4: Controls and Procedures

Evaluation of disclosure controls and procedures. Under the supervision and with the participation of our management, including our Chief Executive Officer and our Chief Financial Officer, we evaluated the effectiveness of our disclosure controls and procedures, as such term is defined under Rule 13a-15(e) promulgated under the Securities Exchange Act of 1934, as amended. Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective as of the end of the period covered by this annual report.

Changes in internal control over financial reporting. T here have been no changes in our internal control over financial reporting during the quarter ended April 29, 2005 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Limitations of the effectiveness of internal control. 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. Notwithstanding these limitations, our disclosure controls and procedures are designed to provide reasonable assurance of achieving their objectives. Our Chief Executive Officer and Chief Financial Officer have concluded that our disclosure controls and procedures are, in fact, effective at the “reasonable assurance” level.

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.

On March 11 and April 19, 2005, purported securities class action complaints were filed in the United States District Court, Northern District of California: Berson v. Applied Signal Technology Inc., No. 4:05-cv-1027 (SBA) (N.D. Cal.) and Sameyah v. Applied Signal Technology Inc., No.4:05-cv-1615 (SBA) (N.D. Cal.). The complaints, which are substantially identical, are brought on behalf of a putative class of persons who purchased the Company’s securities during a class period of May 25, 2004 through February 22, 2005. The complaints name the Company, its Chief Executive Officer, and its Chief Financial Officer as defendants, and allege that false and misleading statements regarding the Company were issued during the class period. A putative class member has moved for appointment as lead plaintiff, and the litigation is in the preliminary stage. We believe that there are meritorious defenses against this litigation and intend to vigorously defend it. However, due to the inherent uncertainties of litigation, we cannot accurately predict the ultimate outcome of the litigation. Any unfavorable outcome of the litigation could have an adverse impact on our business, financial condition, and results of operation.

Item 2: Unregistered Sales of Equity Securities and Use of Proceeds

None.

Item 3: Defaults Upon Senior Securities

None.

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

At the annual meeting of our shareholders held on March 9, 2005, 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 2007 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
John P. Devine	10,316,118	225,355
David Elliman	10,136,178	405,295
Robert Richardson	10,494,161	47,312
Gary L. Yancey	10,129,851	411,622

The appointment of Ernst & Young LLP as our independent registered public accounting firm for the fiscal year ending October 31, 2005 was approved and ratified. The number of shares voted and withheld for such nominees were as follows:

For	Against	Withheld
10,430,123	107,869	3,481

Item 5: Other Information

None.

Item 6: Exhibits

Exhibits. See Index to Exhibits.

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, 2005
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James E. Doyle
Vice President and Chief Financial Officer
(Principal Financial and Accounting Officer)

Applied Signal Technology, Inc.
Index to Exhibits

3.1 [1]	Second Amended and Restated Articles of Incorporation
3.2 [1]	Amended and Restated Bylaws
4.1 [1]	Specimen Common Stock Certificate
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

[1] Incorporated by reference to corresponding Exhibit filed as an Exhibit to Registrant's Registration Statement on Form S-1 filed January 28, 1993 (File No. 33-58168).