

AMERICAN TECHNOLOGY CORP /DE/  
Form PRE 14A  
March 16, 2007

**SCHEDULE 14A INFORMATION**

Proxy Statement Pursuant to Section 14(a) of the Securities Exchange Act of 1934

Filed by the Registrant

Filed by a Party other than the Registrant

Check the appropriate box:

- Preliminary Proxy Statement
- Confidential, for Use of the Commission only (as permitted by Rule 14a-6(e)(2))
- Definitive Proxy Statement
- Definitive Additional Materials
- Soliciting Material Pursuant to § 240.14a-11(c) or § 240.14a-12

**American Technology Corporation**

(Name of Registrant as Specified In Its Charter)

(Name of Person(s) Filing Proxy Statement if Other Than the Registrant)

Payment of Filing Fee (Check the appropriate box)

- No fee required.
- Fee computed on table below per Exchange Act Rules 14a-6(i)(4) and 0-11.

1. Title of each class of securities to which transaction applies:

2. Aggregate number of securities to which transaction applies:

3. Per unit price or other underlying value of transaction computed pursuant to Exchange Act Rule 0-11 (Set forth the amount on which the filing fee is calculated and state how it was determined):

4. Proposed maximum aggregate value of transaction:



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6. Amount Previously Paid:

7. Form, Schedule or Registration Statement No.:

8. Filing Party:

9. Date Filed:

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**AMERICAN TECHNOLOGY CORPORATION**

15378 Avenue of Science, Suite 100  
San Diego, California 92128  
(858) 676-1112

**NOTICE OF ANNUAL MEETING OF STOCKHOLDERS**

**TO BE HELD ON MAY 9, 2007**

TO THE STOCKHOLDERS OF AMERICAN TECHNOLOGY CORPORATION:

**Notice Is Hereby Given** that the Annual Meeting of Stockholders of **American Technology Corporation**, a Delaware corporation (the "Company"), will be held on Wednesday, May 9, 2007 at 2:00 p.m. local time, at our principal offices located at 15378 Avenue of Science, Suite 100, San Diego, California 92128.

1. To elect directors to serve for the ensuing year and until their successors are elected;
2. To ratify the selection of Swenson Advisors, LLP as the independent registered public accounting firm of the Company for its fiscal year ending September 30, 2007;
3. To approve amendments to the Company's 2005 Equity Incentive Plan;
4. To approve certain terms of the Company's financing that occurred in August 2006; and
5. To transact such other business as may properly come before the meeting or any adjournment or postponement thereof.

The foregoing items of business are more fully described in the Proxy Statement accompanying this Notice.

**I strongly encourage you to sign up for electronic delivery of our future annual reports and proxy materials in order to conserve natural resources and help us save costs in producing and distributing these materials.** For more information, please see "Electronic Delivery of Proxy Materials and Annual Reports" on page 2 of the Proxy Statement.

The Board of Directors has fixed the close of business on March 20, 2007, as the record date for the determination of stockholders entitled to notice of and to vote at this Annual Meeting and at any adjournment or postponement thereof.

By Order of the Board of Directors

/s/ Elwood G. Norris

Elwood G. Norris

Chairman of the Board

San Diego, California  
March 30, 2007

**ALL STOCKHOLDERS ARE CORDIALLY INVITED TO ATTEND THE MEETING IN PERSON. WHETHER OR NOT YOU EXPECT TO ATTEND THE MEETING, PLEASE COMPLETE, DATE, SIGN AND RETURN THE ENCLOSED PROXY AS PROMPTLY AS POSSIBLE IN ORDER TO ENSURE YOUR**

**REPRESENTATION AT THE MEETING. EVEN IF YOU HAVE GIVEN YOUR PROXY, YOU MAY STILL VOTE IN PERSON IF YOU ATTEND THE MEETING. PLEASE NOTE, HOWEVER, THAT IF YOUR SHARES ARE HELD OF RECORD BY A BROKER, BANK OR OTHER NOMINEE AND YOU WISH TO VOTE AT THE MEETING, YOU MUST OBTAIN FROM THE RECORD HOLDER A PROXY ISSUED IN YOUR NAME.**

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**AMERICAN TECHNOLOGY CORPORATION**

15378 Avenue of Science, Suite 100, San Diego, California 92128  
(858) 676-1112

**PROXY STATEMENT  
FOR ANNUAL MEETING OF STOCKHOLDERS**

To be held May 9, 2007

**INFORMATION CONCERNING SOLICITATION AND VOTING**

**General**

The enclosed proxy is solicited to the holders of common stock on behalf of the Board of Directors of American Technology Corporation, a Delaware corporation, for use at the Annual Meeting of Stockholders to be held on May 9, 2007, at 2:00 p.m. local time (the "Annual Meeting"), or at any adjournment or postponement thereof, for the purposes set forth herein and in the accompanying Notice of Annual Meeting. The Annual Meeting will be held at our principal offices located at 15378 Avenue of Science, Suite 100, San Diego, California 92128. We intend to mail or electronically deliver this proxy statement, the accompanying proxy card and Notice of Annual Meeting on or about March 30, 2007 to all stockholders entitled to vote at the Annual Meeting.

**Solicitation**

We will bear the entire cost of solicitation of proxies, including preparation, assembly, printing and mailing of this proxy statement, the proxy and any additional information furnished to stockholders. Copies of solicitation materials will be furnished to banks, brokerage houses, fiduciaries and custodians holding in their names shares of common stock beneficially owned by others to forward to such beneficial owners. We may reimburse persons representing beneficial owners of common stock for their costs of forwarding solicitation materials to such beneficial owners. Original solicitation of proxies by mail may be supplemented by telephone, telegram or personal solicitation by directors, officers or other regular employees of our company. No additional compensation will be paid to directors, officers or other regular employees for such services.

**Voting Rights and Outstanding Shares**

We have designated a record date of March 20, 2007 for the Annual Meeting. Only stockholders of record at the close of business on the record date will be entitled to notice of and to vote at the Annual Meeting. At the close of business on the record date we had outstanding and entitled to vote [\_\_\_\_\_] shares of common stock.

Except as provided below, on all matters to be voted upon at the Annual Meeting, each holder of record of common stock on the record date will be entitled to one vote for each share held. With respect to the election of directors, stockholders may exercise cumulative voting rights, i.e., each stockholder entitled to vote for the election of directors may cast a total number of votes equal to the number of directors to be elected multiplied by the number of such stockholders shares (on an as-converted basis) and may cast such total of votes for one or more candidates in such proportions as such stockholder chooses. However, no stockholder will be entitled to cumulate votes unless the candidate's name has been placed in nomination prior to the voting and at least one stockholder has given notice at the meeting, prior to the voting, of his or her intention to cumulate votes. Unless the proxyholders are otherwise instructed, stockholders, by means of the accompanying proxy, will grant the proxyholders discretionary authority to cumulate votes.

All votes will be tabulated by the inspector of election appointed for the meeting, who will separately tabulate affirmative and negative votes, abstentions and broker non-votes. Abstentions will be counted towards the tabulation of votes cast on proposals presented to the stockholders for the purposes of determining the presence of a quorum and will have the same effect as negative votes. Broker non-votes are counted towards a quorum, but are not counted for any purpose in determining whether a matter has been approved. If you sign your proxy card or broker voting instruction card with no instructions, your shares will be voted in accordance with the recommendations of the Board.

-1-

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## **Revocability of Proxies**

Any person giving a proxy pursuant to this solicitation has the power to revoke it at any time before it is voted. It may be revoked by filing with the Chairman of the Board at our principal offices, 15378 Avenue of Science, Suite 100, San Diego, California 92128, a written notice of revocation or a duly executed proxy bearing a later date, or it may be revoked by attending the meeting and voting in person. Attendance at the meeting will not, by itself, revoke a proxy.

## **Stockholder Proposals**

The deadline for submitting a stockholder proposal for inclusion in our proxy statement and form of proxy for our 2008 annual meeting of stockholders pursuant to Rule 14a-8 of the Securities and Exchange Commission is December 1, 2007.

Our bylaws also establish an advance notice procedure with respect to certain stockholder proposals and director nominations. If a stockholder wishes to have a stockholder proposal considered at our next annual meeting, the stockholder must give timely notice of the proposal in writing to the Secretary of our company. To be timely, a stockholder's notice of the proposal must be delivered to, or mailed and received at our executive offices not earlier than February 9, 2008 and not later than March 10, 2008; provided, however, that in the event that no annual meeting was held in the previous year or the date of the annual meeting has been changed by more than 30 days from the anniversary of the scheduled date of this year's Annual Meeting, notice by the stockholder to be timely must be so received not earlier than the close of business on the 90th day prior to such annual meeting and not later than the close of business on the later of the 60th day prior to such annual meeting or, in the event we first make public announcement of the date of such annual meeting fewer than 70 days prior to the date of such annual meeting, the close of business on the 10th day following the day on which we first make public announcement of the date of such meeting.

A stockholder's notice to the Secretary must set forth as to each matter the stockholder proposes to bring before the annual meeting: (i) a brief description of the business desired to be brought before the annual meeting and the reasons for conducting such business at the annual meeting, (ii) the name and address, as they appear on our books, of the stockholder proposing such business, (iii) the class and number of shares which are beneficially owned by the stockholder, (iv) any material interest of the stockholder in such business and (v) any other information that is required to be provided by the stockholder pursuant to Regulation 14A under the Exchange Act, in his or her capacity as a proponent to a stockholder proposal.

## **Electronic Delivery of Proxy Materials and Annual Reports**

If you are a stockholder of record, you may request and consent to electronic delivery of our future proxy materials and annual reports by following the instructions on your proxy card. If your shares are held in street name, please contact your broker, bank or other nominee and ask about the availability of electronic delivery. If you select electronic delivery, we will discontinue mailing the proxy materials and annual reports to you beginning next year, and you will be sent an e-mail message notifying you of the Internet address or addresses where you may access the proxy materials and annual report. Your consent to electronic delivery will remain in effect until you revoke it.

### **PROPOSAL ONE ELECTION OF DIRECTORS**

There are five nominees for Board positions. Each director to be elected will hold office until the next annual meeting of stockholders and until his or her successor is elected and has qualified, or until such director's earlier death, resignation or removal. Each nominee listed below is currently a director of our company. Four of the directors were elected by the stockholders at our 2006 annual meeting. One of the directors, Laura M. Clague, was elected to our



Board in February 2007, based on the recommendation of our Nominating and Governance Committee following a recommendation by our Chief Executive Officer. We encourage our Board members to attend our annual meetings of stockholders. All four nominees who were members of our the Board at the time of the 2006 annual meeting of stockholders attended the 2006 annual meeting of stockholders.

-2-

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Shares represented by executed proxies will be voted, if authority to do so is not withheld, for the election of the five nominees named below, subject to the discretionary power to cumulate votes. In the event that any nominee should be unavailable for election as a result of an unexpected occurrence, such shares will be voted for the election of such substitute nominee as management may propose. Each person nominated for election has agreed to serve if elected and management has no reason to believe that any nominee will be unable to serve.

The five candidates receiving the highest number of affirmative votes cast at the meeting will be elected directors.

**Our Board of Directors Recommends a vote IN FAVOR of each named nominee**

**Nominees**

The names of the nominees and certain information about them are set forth below:

<b>Name</b>	<b>Age</b>	<b>Position and Offices</b>	<b>Director Since</b>
Elwood G. Norris	68	Chairman and Director	1980
Thomas R. Brown	56	Director, President, Chief Executive Officer, Secretary and Interim Chief Financial Officer	2006
Daniel Hunter	57	Director	2001
Raymond C. Smith	63	Director	2006
Laura M. Clague	48	Director	2007

**Elwood G. Norris**, age 68, has been a director of our company since August 1980. Mr. Norris served as Chief Executive Officer from October 2000 until February 2003. He currently serves as Chairman of the Board, an executive position, in which he serves in a technical advisory role to our company and acts as a spokesman for our products. He served as President from August 1980 to February 1994. Mr. Norris managed our research and development activities as Chief Technology Officer through December 2000. From 1988 to November 1999, he was a director and Chairman of e.Digital Corporation, a public company engaged in electronic product development, distribution and sales. During that period, he also held various other executive officer positions at e.Digital. From August 1989 to October 1999, he served as director and held various executive officer positions with Patriot Scientific Corporation, a public company engaged in the development of microprocessor technology and in patent licensing. He is an inventor with 47 U.S. patents, primarily in the fields of electrical and acoustical engineering. He is the inventor of our HyperSonic Sound and other technologies. In April 2005, he was named as the 2005 recipient of the \$500,000 Lemelson-MIT Prize for his many inventions including HyperSonic Sound.

**Thomas R. Brown**, age 56, was appointed to our Board of Directors on March 24, 2006 and was appointed as President and Chief Executive Officer in August 2006 and Interim Chief Financial Officer in September 2006. Mr. Brown temporarily resigned from the Board on September 5, 2006 upon the commencement of his term as President and Chief Executive Officer in order for us to maintain compliance with the rules of the NASDAQ Stock Market requiring us to have a majority of independent directors. Mr. Brown was reappointed to the Board on September 22, 2006. Mr. Brown served as President of BrownThompson Executive Search, a financial executive search firm, from April 2005 to August 2006. Mr. Brown was employed by Sony Electronics, Inc. from February 1988 to September 2004. From April 2001 to September 2004, Mr. Brown was Executive Vice President and Deputy President of the Engineering and Manufacturing division of Sony Electronics, Inc., where he was responsible for supply chain operations including Information Technology, Procurement, Customer Service, North American Manufacturing Operations and Finance. From April 2000 to September 2004, Mr. Brown was concurrently the Executive Vice President and President of Information Technology Division for Sony Electronics, where he was responsible for establishing the North American personal computer manufacturing division. Mr. Brown is a member of the board of directors of Mad Catz Interactive (AMEX/TSX: MCZ), a provider of video game accessories. Mr. Brown obtained a

B.A. in Economics from Rutgers University in 1973. Mr. Brown is also a certified public accountant.

-3-

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**Daniel Hunter**, age 57, has been a director of our company since May 2001. Mr. Hunter has been a licensed certified public accountant for the past twenty-five years. He obtained his accounting degree from the University of Utah in 1975. For the past twenty years, Mr. Hunter has operated his own law offices specializing in business and tax law. He obtained his Juris Doctor degree from the University of Seattle in 1978.

**Raymond C. Smith**, age 63, has been a director of our company since March 15, 2006. Admiral Smith served 31 years in the U.S. Navy SEALs until his retirement in 2001. He held various leadership positions, most recently Director of Assessment of the Office of the Chief of Naval Operations, where he directed capability assessment for the U.S. Navy. During his service with the Navy SEALs, Admiral Smith held positions based in San Diego, California, Tampa, Florida and Newport, Rhode Island. From 2001 to 2002, Admiral Smith was Chief Operating Officer of Cathedral of Our Lady of Angels in a Los Angeles, where he supervised all business activities within the Cathedral complex. From 2003 to 2005, Admiral Smith was President of Seraphim Realty Foundation, a Los Angeles charitable organization dedicated to assisting charities with donated real estate as a means of increasing their endowments. Admiral Smith is a director of EP Global Communications, Inc. (OTCBB: EPGL), publisher of Exceptional Parent magazine and provider of other services for families of people with disabilities and special health care needs. Admiral Smith obtained a B.S. in Engineering from the U.S. Naval Academy in 1967 and an M.S. in Oceanography from the Naval Postgraduate School in 1974.

**Laura M. Clague**, age 48, was appointed to our Board of Directors in February 2007. Ms. Clague is the executive director and corporate controller of Amylin Pharmaceuticals, Inc., a biopharmaceutical company, where she has served since 2003. From 1988 to 1999, Ms. Clague was the director of finance and accounting operations, controller and accounting manager at Sony Electronics, Inc. From 1985 to 1988, Ms. Clague served as internal audit supervisor at Cubic Corporation. From 1982 to 1985, Ms. Clague held various audit positions at KPMG, the last of which was audit supervisor. Ms. Clague is a certified public accountant, and has a B.S. in Business Administration from Menlo College.

## **BOARD AND COMMITTEE MATTERS AND CORPORATE GOVERNANCE MATTERS**

### **Corporate Governance**

We maintain a corporate governance page on our website which includes key information about our corporate governance initiatives, including our Code of Business Conduct and Ethics, our Charters for the committees of the Board of Directors, and our Whistleblower Protection Policy. The corporate governance page can be found at [www.atcsd.com](http://www.atcsd.com), by clicking on "Investors," and then on "Corporate Governance."

Our policies and practices reflect corporate governance initiatives that are designed to be compliant with the listing requirements of The NASDAQ Stock Market and the corporate governance requirements of the Sarbanes-Oxley Act of 2002, including:

- A majority of our Board members are independent of our company and our management;
- All members of our standing Board committees—the Audit Committee, the Compensation Committee, and the Nominating and Governance Committee—are independent;
- The independent members of our Board of Directors meet regularly without the presence of management;
- We have a clear code of business conduct and ethics that applies to our principal executive officers, our directors and all of our employees, and is monitored by our Audit Committee;



- The charters of the board committees clearly establish their respective roles and responsibilities; and
- We have a hotline available to all employees, and our Audit Committee has procedures in place for the anonymous submission of employee complaints on accounting, internal accounting controls, or auditing matters.

### **Board of Directors**

Our Board of Directors currently consists of five directors: Elwood G. Norris (Chairman), Thomas R. Brown, Daniel Hunter, Raymond C. Smith, and Laura M. Clague. During the fiscal year ended September 30, 2006 our Board of Directors held 16 meetings and acted by unanimous written consent 3 times. All directors attended at least 75% of the aggregate of the total number of the meetings of the Board of Directors and the total number of meetings held by all committees of the Board of Directors on which he served (in each case during the period in which he served), except for Admiral Smith.

### **Independence of the Board of Directors**

As required under the NASDAQ Stock Market listing standards, a majority of the members of a listed company's board of directors must qualify as "independent," as affirmatively determined by the board of directors.

After review of all relevant transactions or relationships between each director, or any of his family members, and us, our senior management and our independent registered public accounting firm, our Board of Directors has affirmatively determined that Mr. Hunter, Admiral Smith and Ms. Clague are independent directors within the meaning of the applicable NASDAQ listing standards.

### **Executive Sessions**

As required under NASDAQ listing standards, during the calendar year ended December 31, 2006, our independent directors met at least twice in regularly scheduled executive sessions at which only independent directors were present.

### **Stockholder Communications with the Board of Directors**

We have adopted a formal process by which stockholders may communicate with our Board of Directors. The Board recommends that stockholders initiate any communications with the Board in writing and send them in care of the investor relations department by mail to our principal offices, 15378 Avenue of Science, Suite 100, San Diego, CA 92128. This centralized process will assist the Board in reviewing and responding to stockholder communications in an appropriate manner. The name of any specific intended Board recipient should be noted in the communication. The Board has instructed the investor relations department to forward such correspondence only to the intended recipients; however, the Board has also instructed the investor relations department, prior to forwarding any correspondence, to review such correspondence and, in its discretion, not to forward certain items if they are deemed of a personal, illegal, commercial, offensive or frivolous nature or otherwise inappropriate for the Board's consideration. In such cases, that correspondence will be forwarded to the company's Secretary for review and possible response. This information is also contained on our website at [www.atcsd.com](http://www.atcsd.com).

### **Information Regarding the Board of Directors Committees**

During the fiscal year ended September 30, 2006, the Board had three standing committees: the Audit Committee, the Compensation Committee and the Nominating and Governance Committee. The current charters for the Audit Committee, the Compensation Committee and the Nominating and Governance Committee are included as Annexes

1, 2 and 3. The charters have been adopted, and in some cases amended and restated to, among other things, reflect changes to the NASDAQ listing standards and SEC rules adopted to implement provisions of the Sarbanes-Oxley Act of 2002. The charters can also be found on our website at [www.atcsd.com](http://www.atcsd.com).

-5-

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*Audit Committee*

Our Board of Directors has a separately designated standing Audit Committee established in accordance with Section 3(a)(58) of the Securities Exchange Act of 1934. The Audit Committee oversees our corporate accounting and financial reporting processes. Among other functions, the Audit Committee:

- evaluates the performance of and assesses the qualifications of the independent registered public accounting firm;
- engages the independent registered public accounting firm;
- determines whether to retain or terminate the existing independent registered public accounting firm or to appoint and engage a new independent registered public accounting firm;
- confers with senior management and the independent registered public accounting firm regarding the adequacy and effectiveness of financial reporting;
- reviews and approves the retention of the independent registered public accounting firm to perform any proposed permissible non-audit services;
- resolves any disagreements between management and the independent registered public accounting firm;
- considers the effectiveness of our company's internal control system, including information technology security and control;
- understands the scope of the independent registered public accounting firm's review of internal control over financial reporting, and obtains reports on significant findings and recommendations, together with management's responses;
- monitors the rotation of partners of the independent registered public accounting firm on our audit engagement team as required by law;
- oversees procedures, as required under applicable law, for the receipt, retention and treatment of complaints received by us regarding accounting, internal accounting controls or auditing matters and the confidential and anonymous submission by employees of concerns regarding questionable accounting or auditing matters;
- reviews the procedures for communicating the code of business conduct and ethics to our company personnel, and for monitoring compliance therewith;
- reviews annually the Audit Committee's written charter and the committee's performance and reports the same to the Board;
- reviews the financial statements to be included in our Annual Report on Form 10-K as well as interim financial reports;
- discusses with management and the independent registered public accounting firm the results of the annual audit and the results in our quarterly financial statements; and
- reviews and approves all related party transactions on an ongoing basis.





The Audit Committee has the authority to retain special legal, accounting or other advisors or consultants as it deems necessary or appropriate to carry out its duties. The Audit Committee is composed of Ms. Clague (Chair) and Mr. Hunter and Admiral Smith. At the beginning of fiscal 2006, Daniel Hunter, Richard M. Wagner and David J. Carter were members of the Audit Committee, and Mr. Hunter served as Chair. In March 2006, the size of the Audit Committee was increased to four directors, and Thomas R. Brown joined the Audit Committee as an independent director and became its Chair. Mr. Wagner retired from the Board at the May 2006 annual meeting of stockholders, and the size of the Audit Committee was then reduced to three directors. Mr. Brown resigned from the Audit Committee in August 2006 upon the Board's appointment of him as President and Chief Executive Officer for a term commencing September 5, 2006, and the vacancy on the Audit Committee was filled by Admiral Smith. Mr. Carter resigned from the Board and all standing committees in February 2007, and Ms. Clague was appointed to the Audit Committee to fill the vacancy created by his resignation. Ms. Clague was also appointed as Chair of the Audit Committee. The Audit Committee met 13 times and acted by unanimous written consent 1 time during fiscal 2006.

The Board of Directors annually reviews the NASDAQ listing standards definition of independence for audit committee members and has determined that all members of our Audit Committee are independent (as independence is currently defined in Rule 4350(d)(2)(A) of the NASDAQ listing standards). Our Board of Directors has determined that each member of the Audit Committee is able to read and understand fundamental financial statements, including our company's balance sheet, income statement and cash flow statement. Our Board of Directors has also determined that Mr. Hunter and Ms. Clague each qualify as an "audit committee financial expert," as defined in applicable SEC rules. In making such determinations, the Board made a qualitative assessment of Mr. Hunter's, and Ms. Clague's level of knowledge and experience based on a number of factors, including each individual's formal education and experience. See "Report of the Audit Committee."

### *Compensation Committee*

The Compensation Committee assists in the implementation of, and provides recommendations with respect to, our general and specific compensation policies and practices for our company's executives. The Compensation Committee also administers our 2002 Stock Option Plan and our 2005 Equity Incentive Plan. Among other functions, the Compensation Committee:

- reviews and approves the performance goals and objectives for executive officers, including our Chief Executive Officer;
- evaluates the CEO's performances in light of those goals and objectives and recommends to the Board the CEO's compensation levels;
- recommends to the Board the compensation of executive officers other than the CEO;
- reports on executive compensation for inclusion in our company's proxy statements;
- reviews annually the Board compensation and makes related recommendations to the Board; and
- reviews annually the Compensation Committee's written charter and the committee's performance and reports the same to the Board.

The Compensation Committee has the authority to retain special legal or other advisors or consultants as it deems necessary or appropriate to carry out its duties. The Compensation Committee is composed of Mr. Hunter (Chair), Admiral Smith, and Ms. Clague. At the beginning of fiscal 2006, Richard M. Wagner, Mr. Hunter and David J. Carter were members of the Compensation Committee, and Mr. Wagner served as Chair. In March 2006, the size of the Compensation Committee was increased to four directors, and Admiral Smith joined the Compensation Committee as an independent director. Later in March 2006, the size of the Compensation Committee was increased to five directors, and Thomas R. Brown joined the Compensation Committee as an independent director. Mr. Wagner retired from the Board at the May 2006 annual meeting of stockholders, and the size of the Compensation Committee was then reduced to four directors, and Mr. Hunter became Chair of the Compensation Committee. Mr. Brown resigned from the Compensation Committee in August 2006 upon the Board's appointment of him as President and Chief Executive Officer for a term commencing September 5, 2006, and the size of the Compensation Committee was reduced to three directors. Mr. Carter resigned from the Board and all standing committees in February 2007, and Ms.

Clague was appointed to the Compensation Committee to fill the vacancy created by his resignation. The Compensation Committee held 12 meetings and acted by unanimous written consent 3 times during fiscal 2006. See "Report of the Compensation Committee."

-7-

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Each member of the Compensation Committee is independent (as independence is currently defined in Rule 4200(a)(15) of the NASDAQ listing standards), an "outside director" as defined in Section 162(m) of the Internal Revenue Code and a "non-employee director" as defined in Rule 16b-3 under the Securities Exchange Act of 1934.

*Nominating and Governance Committee*

Our Board of Directors established a Nominating and Governance Committee in April 2004. The Nominating and Governance Committee identifies and recommends to the Board individuals qualified to become Board members, reviews and advises the Board with respect to corporate governance principals and policies, and oversees the annual evaluation of the Board's effectiveness. Among other functions, the Nominating and Governance Committee:

- identifies, reviews and evaluates candidates to serve on our Board of Directors;
- makes recommendations to the Board regarding the membership of the committees of our Board;
- reviews annually the Nominating and Governance Committee's written charter and the committee's performance;
- oversees an annual self-evaluation of our Board;
- reviews with the Board the requisite skills and criteria for new Board members and the composition of the Board as a whole;
- oversees a policy for considering shareholder nominees for directors and develops the procedures that must be followed by shareholders in submitting recommendations;
- evaluates director candidates recommended by the shareholders using the criteria and the principles for director selection;
- oversees a procedure for shareholders to communicate with the Board;
- considers conflicts of interest of Board members and senior management, and, to the extent a conflict constitutes a related party transaction, refers the approval of such matter to the Audit Committee;
- oversees director orientation, continuing education programs, director retirement policies and resignation of directors from the Board; and
- is responsible for corporate governance principles for our company.

The Nominating and Governance Committee has the authority to retain special legal or other advisors or consultants as it deems necessary or appropriate to carry out its duties. The Nominating and Governance Committee is currently composed of Mr. Hunter and Admiral Smith. At the beginning of fiscal 2006, David J. Carter, Mr. Hunter and Richard M. Wagner were members of the Compensation Committee, and Mr. Carter served as Chair. In March 2006, the size of the Nominating and Governance Committee was increased to four directors, and Admiral Smith joined the Nominating and Governance Committee as an independent director. Mr. Wagner retired from the Board at the May 2006 annual meeting of stockholders, and the size of the Nominating and Governance Committee was then reduced to two directors, with Mr. Carter and Admiral Smith remaining members. Mr. Carter resigned from the Board and all standing committees in February 2007. Mr. Hunter was appointed to the Nominating and Governance Committee as Chair to fill the vacancy created by Mr. Carter's resignation in March 2007. The Nominating and Governance Committee held 10 meetings and acted by unanimous written consent 1 time during fiscal 2006.



All members of the Nominating and Governance Committee are independent (as independence is currently defined in Rule 4200(a)(15) of the NASDAQ listing standards).

## **Consideration of Director Nominees**

### *Director Qualifications*

The Nominating and Governance Committee believes that new candidates for director should have certain minimum qualifications, including having the knowledge, capabilities, experience and contacts that complement those currently existing within our company; ability and qualifications to provide our management with an expanded opportunity to explore ideas, concepts and creative approaches to existing and future issues, and to guide management through the challenges and complexities of building a quality company; ability to meet contemporary public company board standards with respect to general governance; stewardship, depth of review, independence, financial certification, personal integrity and responsibility to stockholders; genuine desire and availability to participate actively in the development of our future; and an orientation toward maximizing stockholder value in realistic time frames. The Committee also intends to consider for new Board members such factors as ability to contribute strategically through relevant industry background and experience, on either the vendor or the end user side; strong current industry contacts; ability and willingness to introduce and open doors to executives of potential customers and partners; current employment as the CEO of an acoustic products, media, advertising, military or government supply company larger than our company; independence from our company and current board members; and a recognizable name that would add credibility and value to our company and its stockholders. The Committee may modify these qualifications from time to time.

### *Evaluating Nominees for Director*

The Nominating and Governance Committee reviews candidates for director nominees in the context of the current composition of our Board, our operating requirements and the long-term interests of stockholders. In conducting this assessment, the Committee currently considers, among other factors, diversity, age, skills, and such other factors as it deems appropriate given the current needs of the Board and our company, to maintain a balance of knowledge, experience and capability. In the case of incumbent directors whose terms of office are set to expire, the Nominating and Governance Committee reviews such directors' overall service to our company during their term, including the number of meetings attended, level of participation, quality of performance, and any other relationships and transactions that might impair such directors' independence. In the case of new director candidates, the Committee also determines whether the nominee must be independent, which determination is based upon applicable NASDAQ listing standards, applicable SEC rules and regulations and the advice of counsel, if necessary. The Committee then uses its network of contacts to compile a list of potential candidates, but may also engage, if it deems appropriate, a professional search firm. The Committee conducts any appropriate and necessary inquiries into the backgrounds and qualifications of possible candidates after considering the function and needs of our Board of Directors. The Committee meets to discuss and consider such candidates' qualifications and then selects a nominee for recommendation to our Board of Directors by majority vote. To date, neither the Nominating and Governance Committee nor any predecessor to the Committee has paid a fee to any third party to assist in the process of identifying or evaluating director candidates. To date, neither the Nominating and Governance Committee nor any predecessor to the Committee has rejected a timely director nominee from a stockholder or group of stockholders that beneficially owned, in the aggregate, more than 5% of our voting stock.

### *Stockholder Nominations*

The Committee applies the same guidelines (described above) to stockholder nominees as applied to nominees from other sources. Any stockholder who wishes to recommend for the Nominating and Governance Committee's consideration a prospective nominee to serve on the Board of Directors may do so by giving the candidate's name and

qualifications in writing to our Chairman of the Board at the following address: 15378 Avenue of Science, Suite 100, San Diego, California 92128.

-9-

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## Code Of Business Conduct And Ethics

We have adopted a "Code of Business Conduct and Ethics," a code of ethics that applies to all employees, including our executive officers. A copy of the Code of Business Conduct and Ethics is posted on our Internet site at [www.atcsd.com](http://www.atcsd.com). In the event we make any amendments to, or grant any waivers of, a provision of the Code of Business Conduct and Ethics that applies to the principal executive officer, principal financial officer, or principal accounting officer that requires disclosure under applicable SEC rules, we intend to disclose such amendment or waiver and the reasons therefor on a Form 8-K or on our next periodic report.

## PROPOSAL TWO

### RATIFICATION OF SELECTION OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Audit Committee has selected Swenson Advisors, LLP as our independent registered public accounting firm for the fiscal year ending September 30, 2007. Swenson Advisors, LLP has served as our independent registered public accounting firm since July 2005 and audited our financial statements for the fiscal year ended September 30, 2006. A representative of Swenson Advisors, LLP is expected to be present at the Annual Meeting, will have the opportunity to make a statement if he or she desires to do so, and is expected to be available to respond to appropriate questions. Stockholder ratification of the selection of Swenson Advisors, LLP is not required by our bylaws or otherwise. However, we are submitting the selection of Swenson Advisors, LLP to the stockholders for ratification as a matter of good corporate practice. If the stockholders fail to ratify the selection, the Audit Committee will consider whether or not to retain that firm. Even if the selection is ratified, the Audit Committee in its discretion may direct the appointment of a different independent registered public accounting firm at any time during the year if it determines that such a change would be in the best interest of our company and our stockholders.

The affirmative vote of a majority of the votes cast at the meeting, either in person or by proxy, is required to ratify the selection of Swenson Advisors, LLP. Abstentions will be counted toward the tabulation of votes cast on proposals presented to the stockholders for the purpose of determining a quorum and will have the same effect as negative votes. Broker non-votes are counted towards a quorum, but are not counted for any purpose in determining whether this matter has been approved.

### Independent Registered Public Accountants Fees

The following table presents fees billed by Swenson Advisors, LLP for professional services rendered for the fiscal years ended September 30, 2006 and 2005.

	2006	2005
Audit Fees (1)	\$ 561,630	\$ 430,500
Audit Related Fees (2)	\$ 29,800	—
Tax Fees (3)	—	—
All Other Fees (4)	—	—
<b>Total</b>	<b>\$ 591,430</b>	<b>\$ 430,500</b>

(1) Audit Fees include fees and expenses for professional services rendered in connection with the audit of our financial statements for those years, reviews of the financial



statements included in each of our quarterly reports on Form 10-Q during those years and services that are normally provided by the independent registered public accounting firm in connection with statutory and regulatory filings or engagements. Audit fees also included the audit of management's report on the effectiveness of our company's internal control over financial reporting, as required by Section 404 of the Sarbanes-Oxley Act of 2002.

- (2) Audit Related Fees consist of fees billed for assurance related services that are reasonably related to the performance of the audit or review of our financial statements and are not reported under "Audit Fees." Included in Audit Related Fees are fees and expenses related to reviews of registration statements and SEC filings other than Forms 10-K and 10-Q.
- (3) Tax Fees include the aggregate fees paid by us during the fiscal year indicated for professional services for tax compliance, tax advice and tax planning. No such fees were billed by Swenson Advisors for fiscal 2006 or 2005.
- (4) All Other Fees consist of fees for products and services other than the services reported above. No such fees were billed by Swenson Advisors for fiscal 2006 or 2005.

-10-

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### Audit Committee Pre-Approval Policies and Procedures

All audit and non-audit services are pre-approved by the Audit Committee, which considers, among other things, the possible effect of the performance of such services on the registered public accounting firm's independence. The Audit Committee pre-approves the annual engagement of the principal independent registered public accounting firm, including the performance of the annual audit and quarterly reviews for the subsequent fiscal year, and pre-approves specific engagements for tax services performed by such firm. The Audit Committee has also established pre-approval policies and procedures for certain enumerated audit and audit related services performed pursuant to the annual engagement agreement, including such firm's attendance at and participation at board and committee meetings; services of such firm associated with SEC registration statements, periodic reports and other documents filed with the SEC or other documents issued in connection with securities offerings, such as comfort letters and consents; such firm's assistance in responding to any SEC comments letters; and consultations with such firm as to the accounting or disclosure treatment of transactions or events and/or the actual or potential impact of final or proposed rules, standards or interpretations by the SEC, Public Company Accounting Oversight Board (PCAOB), Financial Accounting Standards Board (FASB), or other regulatory or standard-setting bodies. The Audit Committee is informed of each service performed pursuant to its pre-approval policies and procedures.

The Audit Committee has considered the role of Swenson Advisors, LLP in providing services to us for the fiscal year ended September 30, 2006 and has concluded that such services are compatible with such firm's independence.

### Our Board of Directors recommends a vote IN FAVOR of Proposal Two

#### ADDITIONAL INFORMATION

#### Management

Set forth below is information regarding our executive officers. All executive officers serve at the pleasure of the Board of Directors.

Name	Age	Position
Elwood G. Norris*	67	Chairman of the Board
Thomas R. Brown*	56	President, Chief Executive Officer, Secretary and Interim Financial Officer
Karen Jordan	36	Chief Accounting Officer
James Croft, III	53	Senior Vice President, Research and Development

\* Biographical information about Elwood G. Norris and Thomas R. Brown is set forth under Proposal One above.

**Karen Jordan**, age 36, joined our company in November 2005 as Director of Finance, and in December 2005 was appointed as Chief Accounting Officer. From July 2003 to November 2005, Ms. Jordan was a self-employed bankruptcy executive, managing the Estates of LCS Management, Inc. and LCS West, Inc. From January 2001 to July 2003, Ms. Jordan was Corporate Controller with LifeCare Solutions, Inc., a provider of integrated home healthcare products and services. From June 1996 to January 2001, Ms. Jordan held various positions with Quidel Corporation, a developer and manufacturer of diagnostic tests for detection of a variety of medical conditions and illnesses. At the time Ms. Jordan left Quidel Corporation, she held the position of Assistant Controller. Ms. Jordan is a Fellow Chartered Accountant in Ireland. Ms. Jordan received her Associate Chartered Accountant license from the Institute of Chartered Accountants in Ireland in 1993.



**James Croft, III**, age 53, joined our company in October 1997 as Vice President of Engineering. In December 2000, he was appointed Chief Technology Officer. As part of our March 2003 reorganization, Mr. Croft was appointed Senior Vice President of Research and Development. In August 2005, he was appointed as Chief Technology Officer and Vice President of Development. From October 1992 to October 1997 he was an executive with Carver Corporation, then a publicly traded high-end audio supplier. He was appointed Vice President of Marketing and Product Development for Carver Corporation in March 1993 and Vice President Research and Development in February 1995. From 1990 through October 1992 Mr. Croft held various positions at Dahlquist, Inc., a loudspeaker manufacturer, including Vice President of Research and Development. Mr. Croft is also a member of the board of directors of Definitive Audio, Inc., a Seattle audio specialty retailer that he co-founded in 1975 and managed until 1985.

### SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT

The following table sets forth certain information regarding the ownership of our common stock as of February 16, 2007 by: (i) each director; (ii) each of the named executive officers reflected in the Summary Compensation Table; (iii) all our executive officers and directors as a group; and (iv) all those known by us to be beneficial owners of more than five percent of our common stock.

Title of Class	Name and Address of Beneficial Owner	Amount & Nature of Beneficial Ownership (1)	Percent of Class (1)
Common Stock	Elwood G. Norris 15378 Avenue of Science Ste. 100 San Diego, California 92128	4,048,015 (2)	13.3%
Common Stock	Thomas R. Brown 15378 Avenue of Science Ste. 100 San Diego, California 92128	105,834 (3)	*
Common Stock	Austin W. Marx and David M. Greehouse 527 Madison Avenue, Ste. 2600 New York, NY 10022	4,825,920 (4)	15.4%
Common Stock	Laura M. Clague 15378 Avenue of Science Ste. 100 San Diego, California 92128	—	—
Common Stock	Daniel Hunter 15378 Avenue of Science Ste. 100 San Diego, California 92128	157,875 (5)	*
Common Stock	Raymond C. Smith 15378 Avenue of Science Ste. 100 San Diego, California 92128	30,500 (6)	*
Common Stock	James Croft, III 15378 Avenue of Science Ste. 100	129,009 (7)	*

San Diego, California 92128

-12-

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Title of Class	Name and Address of Beneficial Owner	Amount & Nature of Beneficial Ownership (1)	Percent of Class (1)
Common Stock	Karen Jordan 15378 Avenue of Science Ste. 100 San Diego, California 92128	26,042 (6)	*
Common Stock	Kalani Jones 15378 Avenue of Science Ste. 100 San Diego, California 92128	— (8)	—
Common Stock	John R. Zavoli 15378 Avenue of Science Ste. 100 San Diego, California 92128	— (8)	—
Common Stock	Bruce Gray 15378 Avenue of Science Ste. 100 San Diego, California 92128	— (8)	—
Common Stock	Alan J. Ballard 15378 Avenue of Science Ste. 100 San Diego, California 92128	— (8)	—
All directors & executive officers as a group (7 persons)		4,497,275 (9)	14.7%

\* Less than 1%.

*See below for footnote disclosure.*

- (1) Beneficial ownership is determined in accordance with the rules of the SEC and generally includes voting or investment power with respect to securities. Except as otherwise indicated below, this table is based on information supplied by officers, directors and principal stockholders. The inclusion in this table of such shares does not constitute an admission that the named stockholder is a direct or indirect beneficial owner of, or receives the economic benefit of, such shares. Percentage of class is based on 30,093,227 shares of common stock outstanding on February 16, 2007. Except as otherwise stated below, each of the named persons has sole voting and investment power with respect to the shares shown (subject to community property laws).
- (2) Includes 3,825,515 shares held by a family trust for which Mr. Norris serves as trustee, 37,500 shares issuable upon exercise of a warrant held by such trust, and 185,000 shares issuable upon the exercise of outstanding stock options within 60 days of February 16, 2007.
- (3) Includes 95,834 issuable upon exercise of outstanding stock options within 60 days of February 16, 2007.
- (4) Beneficial joint ownership by Mr. Marx and Mr. Greenhouse is based solely on information as of December 31, 2006 as set forth in Schedule 13G/A filed on February 14, 2007. Consists of 3,586,163 shares and 1,179,117 warrants to purchase 1,239,757 shares held by the following entities: 1,574,806 shares and 537,319 warrants to purchase 565,196 shares owned by Special Situations Fund III QP, L.P., 137,082 shares and

46,872 warrants to purchase 49,315 shares owned by Special Situations Fund III, L.P., 550,640 shares and 177,871 warrants to purchase 190,605 shares owned by Special Situations Private Equity Fund, L.P., 183,435 shares and 57,729 warrants to purchase 60,155 shares owned by Special Situations Technology Fund, L.P., and 1,140,200 shares and 359,326 warrants to purchase 374,486 shares owned by Special Situations Technology Fund II, L.P. MGP Advisors Limited Partnership, or MGP, is the general partner of the Special Situations Fund III, L.P. and the Special Situations Fund III QP, L.P. and AWM Investment Company, Inc., or AWM, is the general partner of MGP. SST Advisers, L.L.C., or SSTA, is the general partner of the Special Situations Technology Fund, L.P. and Special Situations Technology Fund II, L.P. MG Advisers, L.L.C., or MG, is the general partner of the Special Situations Private Equity Fund, L.P. AWM is the investment adviser to Special Situations Fund III QP, L.P., Special Situations Technology Fund, L.P., Special Situations Technology Fund II, L.P. and Special Situations Private Equity Fund, L.P. Austin W. Marx and David M. Greenhouse are the principal owners of MGP, AWM, SSTA and MG, and are principally responsible for the selection, acquisition, voting and disposition of the portfolio securities by each investment adviser on behalf of its fund. Both Messrs. Marx and Greenhouse share voting and dispositive power with respect to shares held by these stockholders.

- (5) Includes 62,000 shares held by spouse, 6,000 shares held by Profit Sharing Trust and 89,875 shares issuable upon the exercise of outstanding stock options within 60 days of February 16, 2007.
- (6) Consists of shares issuable upon exercise of outstanding stock options within 60 days of February 16, 2007.
- (7) Includes 124,959 shares issuable upon the exercise of outstanding stock options within 60 days of February 16, 2007.
- (8) We have no information on ownership by these former executive officers.
- (9) Includes 522,210 shares issuable upon exercise of outstanding stock options within 60 days of February 16, 2007 and 37,500 shares issuable upon exercise of warrants.

## **SECTION 16(a) BENEFICIAL OWNERSHIP REPORTING COMPLIANCE**

Section 16(a) of the Exchange Act requires our officers, directors and persons who own more than 10% of any class of our securities registered under Section 12(g) of the Exchange Act to file reports of ownership and changes in ownership with the SEC. Officers, directors and greater than 10% stockholders are required by SEC regulations to furnish us with copies of all Section 16(a) forms they file.

Based solely on a review of copies of such reports furnished to us and written representations that no other reports were required during the fiscal year ended September 30, 2006, we believe that all persons subject to the reporting requirements pursuant to Section 16(a) filed the required reports on a timely basis with the SEC except that Mr. Norris reported a September 20, 2006 exercise of a warrant on Form 4 late on October 3, 2006.

## **EXECUTIVE COMPENSATION**

### **Compensation of Directors**

In June 2005, upon recommendation of the Compensation Committee, our Board of Directors approved a director compensation plan. Under the plan, each of our non-employee directors was paid a fee of \$1,000 per month, payable quarterly in arrears. No additional amounts were payable for committee participation.

The Compensation Committee awarded options to Admiral Smith, Mr. Brown and Ms. Clague upon joining the Board of Directors as non-employee directors in March 2006, March 2006 and February 2007. Each option was granted under our 2005 Equity Incentive Plan, is exercisable for 50,000 shares of our common stock, has an exercise price equal to the closing price of our common stock reported on the date of grant, has a five year term and vests quarterly over four years, subject to continued service and other conditions. The exercise price for Admiral Smith's option is \$3.32 per share, for Mr. Brown's option is \$3.65 per share, and for Ms. Clague's option is \$4.42 per share.

In February 2007, the Compensation Committee recommended to the Board, and the Board approved, one-time awards of \$5,000 to be made to Mr. Hunter, Admiral Smith and David J. Carter in recognition of their service during management changes and the voluntary review of our historical stock option and stock grants.

In February 2007, the Compensation Committee awarded to incumbent directors Mr. Hunter and Admiral Smith non-statutory options under our 2005 Equity Incentive Plan exercisable for 54,000 shares of our common stock, with an exercise price equal to the closing price of our common stock on the date of grant (which was \$4.37). Such options were vested as to one third of the shares upon grant, and quarterly thereafter through the second anniversary of the date of grant, subject to continuing service to our company.

### **Summary Compensation Table**

Set forth below is information concerning the compensation of each person who served as our Principal Executive Officer and our two other most highly compensated executive officers, other than those who served as Principal Executive Officers, that were serving at September 30, 2006 (representing all of our executive officers serving at that date who earned over \$100,000 in salary and bonus for the fiscal year ending on that date and who did not serve as Principal Executive Officer), and two additional individuals that served as executive officers during the fiscal year ended September 30, 2006 but were no longer serving at September 30, 2006. We refer to each of such persons as a "named executive officer".



## Summary Compensation Table

Name and Principal Position	Fiscal Year	Annual Compensation			Other Annual Compensation	Long Term Compensation Awards Securities	All Other Compensation
		Salary	Bonus	Underlying Options (#)			
Elwood G. Norris, Chairman	2006	\$ 203,846	—	—	100,000	—	
	2005	\$ 200,272	—	—	70,000	—	
	2004	\$ 200,000	—	—	—	-\$ 1,385(1)	
Thomas R. Brown (2) President, Chief Executive Officer and Interim Financial Officer	2006	\$ 22,070	—	—	250,000	\$ 58,500(2)	
John R. Zavoli (3) Former President and Chief Operating Officer	2006	\$ 206,468	—	—	100,000	\$ 136,601(3)	
Kalani Jones (4) Former President and Chief Operating Officer	2006	\$ 38,413	—	—	—	87,293(4)	
	2005	\$ 199,241	—	—	52,500	\$ —	
	2004	\$ 179,808	\$ 50,000(5)	—	125,000	\$ 1,636(1)	
James Croft, III Senior Vice President, Research and Development	2006	\$ 168,173	—	—	—	-\$ 6,514(6)	
	2005	\$ 201,383	—	—	10,000	\$ 18,895(6)	
	2004	\$ 126,690	—	—	—	-\$ 17,572(6)	
Karen Jordan Chief Accounting Officer	2006	\$ 126,538	—	—	30,000	\$ 1,575(1)	
Bruce Gray (7) Vice President, Commercial Products Group	2006	\$ 223,166	—	—	—	-\$ 92,213(7)	
	2005	\$ 107,692	—	—	100,000	—	
Alan J. Ballard (8) Former Vice President - Government and Military Group	2006	\$ 169,573	—	—	—	-\$ 91,346(8)	

(1) Represents matching 401(k) contributions.

(2) Salary includes \$3,000 of director fees for the period prior to being appointed as an executive officer. All other compensation includes \$58,500 paid to BrownThompson Executive Search, an executive search firm controlled by Mr. Brown, for services

provided prior to Mr. Brown's appointment to the board.

- (3) Mr. Zavoli's employment with our company terminated August 17, 2006. Salary includes \$2,000 of post-employment director fees. All other compensation includes severance of \$125,000, post-employment medical payments of \$7,648 and matching 401(k) contributions of \$1,953. See "Employment Arrangements" below for more information.
- (4) Mr. Jones resigned from our company effective October 17, 2005. All other compensation includes severance of \$82,500, post-employment medical payments of \$4,666 and matching 401(k) contributions of \$127. See "Employment Arrangements" below for more information.
- (5) Represents bonus for fiscal 2004 paid in fiscal 2005.
- (6) Includes royalty payments of \$4,080, \$18,895 and \$16,246 for fiscal 2006, 2005 and 2004 respectively. Balance represents matching 401(k) contributions.
- (7) Mr. Gray's employment with our company terminated September 19, 2006. Sales commissions of \$31,796 are included with salary. All other compensation includes severance of \$90,000 and matching 401(k) contributions of \$2,213. See "Employment Arrangements" below for more information.
- (8) Mr. Ballard's employment with our company terminated May 16, 2006. Sales commissions of \$58,562 are included with salary. All other compensation includes severance of \$90,000 and matching 401(k) contributions of \$1,346.

No named executive officer received any form of non-cash compensation from us in the fiscal years ended September 30, 2006, 2005, or 2004, or currently receives any such compensation, in excess of 10% of the total amount of annual salary and bonus reported for the named executive officer above. No named executive officer received a restricted stock award, a stock appreciation right or a long-term incentive plan payout in the fiscal years ended September 30, 2006, 2005, or 2004.

### OPTION GRANTS

The following table shows further information on grants of stock options in fiscal 2006 to the named executive officers reflected in the Summary Compensation Table.

#### Option Grants for Fiscal Year Ended September 30, 2006

Name	Individual Grants		Exercise Price	Expiration Date	Potential Realizable Value at Assumed Annual Rates of Stock Price Appreciation for Option Term (3)	
	Number of Shares of Common Stock Underlying Options Granted (1)	Percent of Total Options Granted to Employees in Fiscal Year			5%	10%
Elwood G. Norris	100,000	7.4%	\$ 4.29	5/03/2011	\$ 68,750	\$ 199,099
Thomas R. Brown	50,000	3.7%	\$ 3.65	3/24/2011	\$ 50,421	\$ 111,418
Karen Jordan	200,000	14.9%	\$ 3.33	9/05/2011	\$ 184,004	\$ 406,600
John R. Zavoli	30,000	2.2%	\$ 4.77	11/21/2010	\$ 39,539	\$ 87,364
(2)	100,000	7.4%	\$ 4.78	11/01/2009	\$ 132,063	\$ 291,824

(1) All options granted under our 2005 Equity Incentive Plan and were granted at an exercise price equal to the fair market value on the date of grant, except the option to Mr. Norris, which was granted at an exercise price equal to 110% of the fair market value on the date of grant. Options vest as to 1/4 of the shares on the first anniversary of the date of grant and as to 1/16<sup>th</sup> of the shares each quarter thereafter, subject to continuing service to our company.

(2) Mr. Zavoli's employment with our company terminated August 17, 2006. None of the shares subject to such grant vested.

(3) Potential gains are net of exercise price, but before taxes associated with exercise. These amounts represent certain assumed rates of appreciation only, in accordance with the SEC's rules. Actual gains, if any, on stock option exercises are dependent on the future performance of the common stock, overall market conditions and the option holder's continued employment through the vesting period. The amounts reflected in this table may not necessarily be achieved.

#### Stock Option Exercises and Holdings

The following table shows the information on each exercise of options during fiscal 2006 and unexercised options and the value of options held at September 30, 2006 by each of the named executive officers reflected in the Summary Compensation Table.

**Aggregate Option Exercises in Last Fiscal Year and Fiscal Year-End Option Values**

Name	Shares Acquired on Exercise	Value Realized	Number of Shares of Common Stock Underlying Unexercised Options Held at Fiscal Year End		Value of Unexercised In-The-Money Options at Fiscal Year End (1)	
			Exercisable	Unexercisable	Exercisable	Unexercisable
<b>Elwood G. Norris</b>	50,000	\$ 40,000	126,250	143,750	\$ 36,660	—
<b>Thomas R. Brown</b>	—	—	—	250,000	—	\$ 106,500
<b>James Croft, III</b>	17,000	\$ 16,400	115,375	5,625	\$ 53,440	—
<b>Karen Jordan</b>	—	—	—	30,000	—	—

(1) Based on the closing price reported on the NASDAQ Capital Market on September 29, 2006 of \$3.82 per share.

(2) Based on the closing price reported on the NASDAQ Capital Market on the date of exercise.

(3) Based on the closing price reported on the NASDAQ Capital Market on the date of exercise. The option and the shares acquired upon exercise are subject to a domestic relations order. Mr. Croft disclaims beneficial ownership of the shares acquired upon exercise of the option except to the extent of his pecuniary interest therein.

We do not have any stock appreciation rights plans in effect and we have no long-term incentive plans, as those terms are defined in SEC regulations. During the fiscal year ended September 30, 2006, we did not adjust or amend the exercise price of stock options awarded to the named executive officers. We have no defined benefit or actuarial plans covering any named executive officer.

## EMPLOYMENT ARRANGEMENTS

We entered into the following employment arrangements with each of the named executive officers reflected in the Summary Compensation Table, and each of our current executive officers.

Mr. Elwood G. Norris - Effective September 1, 1997, we entered into a three year employment contract with Mr. Norris, for his services as Chief Technology Officer. The three-year term expired on August 31, 2000, but the agreement remains in effect until one party gives thirty days advance notice of termination to the other. Mr. Norris now serves as Chairman under the term of this agreement. The agreement, as amended by the Compensation Committee, provides for a base salary of \$16,667 per month. The agreement provides that Mr. Norris will participate in bonus, benefit and other incentives at the discretion of the Board of Directors. Mr. Norris has agreed not to disclose trade secrets and has agreed to assign certain inventions to us during employment. We also provide Mr. Norris with an automobile, the lease payments for which are currently \$720 per month. We are also obligated to pay Mr. Norris certain royalties. See "Certain Transactions" below.

Mr. Thomas R. Brown - Effective August 23, 2006 we entered into a letter agreement with Mr. Brown pursuant to which he was appointed as our president and chief executive officer commencing September 5, 2006. Mr. Brown was also appointed as interim chief financial officer on September 19, 2006. The terms of Mr. Brown's employment did not change in connection with his appointment as interim chief financial officer. Mr. Brown was a director of our company and was a member of the audit and compensation committees from March 24, 2006 until he resigned in connection with entering into the letter agreement to facilitate our company's compliance with NASDAQ corporate governance requirements. He was reappointed to the board on September 22, 2006. The letter agreement provides for a base salary of \$250,000 per year. In connection with his employment, Mr. Brown received a non-statutory stock option to purchase 200,000 shares of common stock under our 2005 Equity Incentive Plan with an exercise price \$3.33 per share, the closing price of our common stock on the start date as reported on the NASDAQ Capital Market. Mr. Brown will be eligible for an annual bonus with respect to fiscal years beginning fiscal 2007 as recommended by the compensation committee and approved by the board. The bonus will be based in part on his achievement of detailed annual goals that will be established by the compensation committee. Mr. Brown's bonus for fiscal 2007 will be based upon the bonus plan described below under the heading "Executive Officer and Employee Incentive Plan". In the event that Mr. Brown's employment is terminated for any reason other than cause, or if he resigns for good reason, he will be entitled to severance equal to one month's salary for each two month period of service, or portion thereof, up to six months' salary. He will also be entitled to continuation of his company-provided health and dental benefits for the same period.

Mr. John R. Zavoli - On October 17, 2005, we entered into a letter agreement with Mr. Zavoli, pursuant to which Mr. Zavoli was appointed as our president and chief operating officer, commencing November 1, 2005. Mr. Zavoli was a director of our company, and was a member of the audit and compensation committees until he resigned the committee appointments in connection with entering into the letter agreement. The letter agreement provided for an annual base salary of \$250,000 and eligibility for an annual bonus, as recommended by the compensation committee and approved by the board of directors. In addition, Mr. Zavoli received an option to purchase 100,000 shares of our common stock on November 1, 2005. Mr. Zavoli's employment was not for a specified period or term of employment and was terminable at-will by us or by Mr. Zavoli for any reason, with or without notice. On August 17, 2006, Mr. Zavoli's employment arrangement with our company terminated. Mr. Zavoli's annual base salary at the time of termination was \$250,000 and he was entitled to severance in the form of post-termination salary continuation and payment by our company of the premiums for extension of benefits under COBRA for a number of months based on his number of months of service, conditioned on his execution of a general release of all known and unknown claims against our company, and the continued effectiveness of such release beyond any statutory revocation period. On September 22, 2006 Mr. Zavoli resigned from his position as a member of our board of directors and entered into a separation and release agreement with our company providing: (a) payments of \$125,000, representing six months of base salary, and (b) payment of health benefit premiums on Mr. Zavoli's behalf for a period not to extend beyond

February 28, 2007 estimated at \$6,210. In addition, the separation and release agreement contained Mr. Zavoli's general release of all claims against our company.

Mr. Kalani Jones - We entered into a letter agreement dated as of August 28, 2003, as amended on October 20, 2003, under which Mr. Jones was employed as our Senior Vice President of Operations. Mr. Jones was later promoted to President and Chief Operating Officer. The letter agreement provided for an annual base salary of \$140,000, a 30% annual performance bonus to be determined by the Compensation Committee and the Board of Directors, and the grant of an option to purchase 75,000 shares of our common stock, which option vested quarterly over a two year period beginning six months after the date of employment. Mr. Jones subsequently received additional option grants. Mr. Jones's employment was terminable at-will by us or Mr. Jones for any reason, with or without notice. On October 17, 2005, Mr. Jones's employment arrangement with our company terminated. Mr. Jones annual base salary at the time of resignation was \$220,000, and he was entitled to an annual performance bonus of up to 50% of his base salary, as determined by the Compensation Committee. On October 20, 2005, we entered into a separation and release agreement with Mr. Jones. The agreement provided for our one-time payment of \$82,500 to Mr. Jones and our payment of health benefit premiums on Mr. Jones's behalf for a period not to extend beyond February 28, 2006 which totaled \$4,666. We also agreed to extend until February 15, 2006 the period of time for which the vested portion of stock options held by Mr. Jones could be exercised; however no options were exercised. In addition, the separation and release agreement contained Mr. Jones's general release of all claims against our company.

Mr. James Croft, III - On August 17, 2005, our Board of Directors approved the appointment of Mr. Croft as our Chief Technology Officer and Vice President of Advanced Development. Mr. Croft has served as our Vice President of Research and Development since February 28, 2000, and, prior to that, as our Vice President of Engineering from September 15, 1997. Mr. Croft is employed pursuant to the terms of an employment agreement dated February 28, 2000, which terms have been orally modified. Under the terms as modified, Mr. Croft's annual salary is \$165,000, and he participates in bonus, benefit and other incentives at the discretion of the Compensation Committee. We presently exclusively license two pre-employment inventions from Mr. Croft through March 2008. We are not currently marketing products using these inventions, and we are not currently paying royalties to Mr. Croft for these inventions. We plan to negotiate further revisions to our agreement with Mr. Croft, including our right to continue the license beyond March 2008. The initial term of the employment agreement dated February 28, 2000 has expired, and as a result, either we or Mr. Croft may terminate his employment for any reason upon thirty days advance notice.

Ms. Karen Jordan - On December 16, 2005, our Board of Directors approved the appointment of Ms. Jordan as our Chief Accounting Officer. Ms. Jordan entered into a letter agreement with our company dated October 26, 2005, and joined our company in November 2005, as director of finance. Ms. Jordan's annual salary is \$140,000 and she participates in bonus, benefit and other incentives at the discretion of the Compensation Committee. Ms. Jordan's employment is not for a specified period or term of employment and is terminable at-will by us or by Ms. Jordan for any reason, with or without notice.

Mr. Bruce Gray - We entered into a letter agreement with Mr. Gray, under which Mr. Gray was employed as our Vice President of Sales and Marketing for our Commercial Group effective March 21, 2005. The letter agreement provided for an initial annual base salary of \$200,000 and an annual sales commission, payable on a quarterly basis, based on revenues and billings. In September 2005, the compensation committee approved the commission plan called for by Mr. Gray's employment agreement. The commission plan governed the payment of Mr. Gray's annual sales bonus for the twelve-month period beginning April 1, 2005, and entitled Mr. Gray to commissions payable based on invoiced net sales of the commercial group on a quarterly basis, calculated as a percentage of quarterly revenue targets for our commercial group. The plan provided for a target commission for the twelve-month period of \$100,000, but commissions could exceed such amount if the commercial group's invoiced net sales exceeded our revenue plan. This plan was modified by us effective for the second quarter of fiscal 2006 to revise the quarterly revenue targets and the commission formula to be based on direct sales by Mr. Gray on personal revenue targets plus an override based on revenue targets for the group supervised by Mr. Gray. The portion payable as override was payable only if revenue targets were achieved, and was capped at 50% of Mr. Gray's base salary. The revised plan provided for an aggregate target commission of approximately \$66,000 for the last three quarters of fiscal 2006, but commissions could exceed such amount if Mr. Gray's direct sales or group sales exceeded revenue targets. In connection with entry into the revised plan, Mr. Gray's base salary was adjusted to \$180,000 per year effective March 16, 2006. Mr. Gray's employment was terminable at-will by us or by Mr. Gray for any reason, with or without notice. On September 19, 2006 Mr. Gray's employment arrangement with our company was terminated. On October 4, 2006, we entered into a separation and release agreement with Mr. Gray. The agreement provided for our one-time payment to Mr. Gray of \$90,000 and Mr. Gray's general release of all claims against our company.

Mr. Alan J. Ballard - On November 17, 2005, our board of directors approved the appointment of Mr. Ballard as our Vice President, Government and Military Division. Mr. Ballard joined our company in January 2004 and has held various positions in our Government Group. Mr. Ballard's employment was terminable at-will by us or Mr. Ballard for any reason, with or without notice. On May 16, 2006 Mr. Ballard's employment arrangement with our company terminated. Mr. Ballard's annual salary at the time of termination was \$145,000, and he was entitled to participate in bonus, benefit and other incentives at the discretion of the Compensation Committee. On October 18, 2006 we entered into a release and settlement agreement with Mr. Ballard and paid \$90,000 for severance and non-wage damages and in consideration of Mr. Ballard's general release of claims against us.

#### **EXECUTIVE OFFICER AND EMPLOYEE INCENTIVE PLAN**

In September 2006, the Compensation Committee recommended, and the Board approved, an incentive plan for fiscal year 2007, that is designed to motivate plan participants to achieve our financial objectives and to reward such participants for their achievements when those objectives are met. Under the incentive plan, target bonus amounts vary based on a percentage of the participant's base salary, and the amount of bonus actually paid to a participant will be based on the achievement by our company of positive income from operations (including the cost of the incentive plan).

All of our employees except sales personnel, including our executive officers, will be entitled to participate in the incentive plan. The target bonuses for our participating executive officers will be 50% of base salary. Participants will be entitled to a bonus of two times the target bonus in the event income from operations exceeds \$1 million for fiscal year 2007, including the cost of the incentive plan.





## COMPENSATION COMMITTEE INTERLOCKS AND INSIDER PARTICIPATION

Messrs. Carter, Hunter, Wagner, Brown and Admiral Smith served on the Compensation Committee during fiscal 2006. At the beginning of fiscal 2006, Messrs. Wagner, Hunter and Carter were members of the Compensation Committee, and Mr. Wagner served as Chair. In March 2006, the size of the Compensation Committee was increased to four directors, and Admiral Smith joined the Compensation Committee as an independent director. Later in March 2006, the size of the Compensation Committee was increased to five directors, and Mr. Brown joined the Compensation Committee as an independent director. Mr. Wagner retired from the Board at the May 2006 annual meeting of stockholders, and the size of the Compensation Committee was then reduced to four directors, and Mr. Hunter became Chair. Mr. Brown resigned from the Compensation Committee in August 2006 upon the Board's appointment of him as President and Chief Executive Officer for a term commencing September 5, 2006, and the size of the Compensation Committee was reduced to three directors. Mr. Carter resigned from the Board and all standing committees in February 2007, and Ms. Clague was appointed to the Compensation Committee to fill the vacancy created by his resignation. The Compensation Committee currently consists of Mr. Hunter (Chair), Admiral Smith and Ms. Clague.

No executive officer of our company (1) served as a member of the compensation committee (or other board committee performing equivalent functions or, in the absence of any such committee, the entire board of directors) of another entity, one of whose executive officers served on our company's Compensation Committee, (2) served as a director of another entity, one of whose executive officers served on our company's Compensation Committee, or (3) served as a member of the compensation committee (or other board committee performing equivalent functions or, in the absence of any such committee, the entire board of directors) of another entity, one of whose executive officers served as a director of our company.

## EQUITY COMPENSATION PLAN INFORMATION

At September 30, 2006, we had two equity incentive plans under which equity securities are or have been authorized for issuance to our employees, consultants or directors: the 2005 Equity Incentive Plan and the 2002 Stock Option Plan. These plans have been approved by our stockholders. The reserve under the 2005 Equity Incentive Plan includes any prior plans that expire or become unexercisable. In addition, from time to time we issue to employees, directors and service providers special stock options, inducement grants and warrants to purchase common shares, and these grants have not been approved by stockholders. The following table sets forth information as of September 30, 2006:

Plan Category	Number of securities to be issued upon exercise of outstanding options, warrants and rights	Weighted-average exercise price of outstanding options, warrants and rights	Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a))
	(a)	(b)	(c)
	1,388,323	\$4.34	1,520,916

Equity compensation plans approved by security holders			
Equity compensation plans not approved by security holders	258,250 <sup>(1)</sup>	\$6.26	—
Total	1,646,573	\$4.64	1,520,916

- (1) Includes (i) 108,250 shares of common stock subject to inducement stock options granted to certain non-executive officer employees from time to time, which options have a weighted-average exercise price of \$9.33 per share, a five year term and generally vest 25% on the first anniversary of the grant date and then 1/16 each quarter thereafter, subject to continued service and other conditions, (ii) 50,000 shares subject to a warrant granted on February 28, 2003, to a financial advisor for consulting services rendered with an exercise price of \$3.63 and an expiration date of April 4, 2008, and (iii) 100,000 shares subject to a warrant granted on September 30, 2002, to another financial advisor for consulting services rendered with an exercise price of \$4.25 and an expiration date of September 30, 2007.

## REPORT OF THE COMPENSATION COMMITTEE ON EXECUTIVE COMPENSATION

*Introductory Note:* The following report is not deemed to be incorporated by reference by any general statement incorporating by reference this proxy statement into any filing under the Securities Act of 1933 or under the Exchange Act, except to the extent that we specifically incorporate this information by reference, and shall not otherwise be deemed soliciting material or filed under such laws.

### **Committee Meetings, Processes and Policies**

The Compensation Committee of the Board of Directors operates under the authority of a Compensation Committee Charter, a copy of which is attached as Appendix 2 to this proxy statement. The primary philosophy of the committee regarding compensation is to offer packages which reward each of the members of senior management proportionately to each person's individual performance and to our company's overall financial performance and growth during the previous fiscal year.

The committee met 12 times and acted by unanimous written consent 3 times during fiscal 2006, and discussed in detail the company's compensation philosophy and practices for employees at all levels. Compensation for employees ranked below Vice President was recommended by their supervisors to the President, who then reported his determinations to the committee. The committee reviews and recommends for approval by the board all compensation for employees ranked Vice President and above.

In determining initial compensation for new executive hires or persons promoted to executive positions, and in reviewing existing executive officers annually, the committee reviews all components of executive officer compensation, including salary, bonus, and stock options held. It is the committee's policy to review the dollar value to the executive and cost to the company of all perquisites and other personal benefits, and all severance and change of control scenarios. Unvested stock options currently held by our executive officers generally provide that if employment is terminated without cause within 24 months after a change in control, such stock options will be considered fully vested upon such termination, and, for options granted under our 2002 Stock Option Plan, the option will remain exercisable for six months after such service terminates. Since these provisions apply generally to all stock options, the committee has not placed special value on this right when determining executive compensation. In connection with all compensation reviews for executive officers, the committee reviews a tally sheet setting forth all the above components, to the extent applicable. The committee did not take into account accumulated (realized and unrealized) stock option gains in its compensation decisions during fiscal 2006, but commenced doing so in November 2006.

*Base salary.* Base salaries for executive officers are reviewed on an annual basis. The committee has historically believed that base salaries should be set in the lower quartile of the Radford Executive Survey, which we used in fiscal years prior to 2006 to set executive salaries. The decision to use the lower quartile reflected in part that the company's revenues were lower than the revenue ranges of the companies in the Radford survey reports, and that the company has not been profitable. The committee has placed greater emphasis on incentive and stock option compensation for its executive officers, creating a deeper link between pay and individual and company performance. During fiscal 2006 base salaries for new executive officers were negotiated by John Zavoli, the Company's former President and Chief Operating Officer, and then presented to the committee for approval. The committee did not increase salaries for existing executive officers during fiscal 2006 as a result of the company's financial performance during fiscal 2006. The committee does however remain open to revisiting the levels of base salaries paid to executives at such time as the company become profitable.

*Bonus compensation.* All of our executive officers are considered for bonus compensation. During fiscal 2005, we had arrangements with certain of our executive officers providing that they would be considered for discretionary bonuses at a certain percentage of their base salaries. None of such arrangements were in existence during fiscal 2006, and we

did not have a formal bonus plan in effect for fiscal 2006. In March 2006, the committee recommended and the board approved payment of discretionary bonuses of \$7,500 to each of two executive officers. These bonuses were recommended by Mr. Zavoli in connection with performance during the first quarter of fiscal 2006. No further interim discretionary bonuses were paid during fiscal 2006, and in light of the company's financial performance for the full fiscal year, the company's new President and Chief Executive Officer, Thomas R. Brown, recommended, and the committee concurred, that no executive officers would be considered for year-end discretionary bonuses.

-20-

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Executive officers in charge of revenue producing business segments also participated in commission arrangements during fiscal 2006. In September 2005, the committee approved a commission plan for our former Vice President, Commercial Products Group, pursuant to the terms of his employment letter. The commission plan governed the payment of that executive's annual sales bonus for the twelve-month period beginning April 1, 2005, and entitled such executive to commissions payable based on invoiced net sales on a quarterly basis, calculated as a percentage of quarterly revenue targets for our commercial products group. The plan provided for a target commission for the twelve-month period of \$100,000, but commissions could exceed such amount if our invoiced net sales exceeded our revenue plan. This plan was modified by the committee effective January 1, 2006 to revise the quarterly revenue targets and the commission formula. See "Employment Arrangements - Mr. Bruce Gray" above. The committee adopted a commission arrangement for our Government Group during fiscal 2005, but did not establish commission rates for fiscal 2006 or any future years. One of the discretionary bonuses of \$7,500 discussed above was awarded to the former Vice President, Government and Military Division, in lieu of the Government Group commission plan.

In September 2006, following a recommendation by Mr. Brown, the committee recommended, and the board approved, an incentive plan for fiscal year 2007 that is designed to motivate plan participants to achieve our financial objectives and to reward such participants for their achievements when those objectives are met. Under the incentive plan, target bonus amounts vary based on a percentage of the participant's base salary, and the amount of bonus actually paid to a participant will be based on the achievement by our company of positive income from operations (including the cost of the incentive plan). All of our employees except sales personnel, including our executive officers, participate in the incentive plan. The target bonuses for our participating executive officers are 50% of base salary. Participants are entitled to a bonus of two times the target bonus in the event income from operations exceeds \$1 million for fiscal year 2007, including the cost of the incentive plan.

While the committee's overall compensation philosophy remains to reward each of the members of senior management proportionately to each person's individual performance and to our company's overall financial performance and growth during the previous fiscal year, the committee approved this incentive plan mindful that it rewards employees based solely on the company's performance as a whole, as measured solely by achievement of positive income from operations. The committee believes that this plan is simpler to understand than a plan with individual targets, and motivates our reduced-size organization to work together to achieve what is considered to be the company's first priority at this time - the reversal of losses from operations. The committee noted in approving this plan that the plan would have to pay for itself - no employees would receive incentive bonuses unless there was sufficient income from operations to offset the cost of those bonuses.

*Long-term incentives.* Our long-term incentive program has consisted of a stock option program pursuant to which our executive officers are periodically granted stock options. Our stock option programs are designed to provide such persons with significant compensation based on our overall performance as reflected in the stock price, to create a valuable retention device through standard two to five year vesting schedules and to help align employees' and stockholders' interests. Options granted during fiscal 2006 were non-statutory stock options, and generally had a five year term, subject to continuing service, and generally vested as to one fourth of the shares on the first anniversary of the grant date, and quarterly thereafter through the fourth anniversary of the date of grant. Stock options are typically granted at the time of hire to new employees, at the time of promotion to certain employees and periodically to a broad group of existing key employees and executive officers.

As indicated above, the company's bonus plan is designed to reward company performance rather than individual performance. The committee continues to reward individual contributions through periodic grants of stock options, the most recent of were made in February 2007 based in part on reviews of individual performance during fiscal 2006. These grants were delayed during the pendency of a "blackout period" under the company's insider trading policy which was in effect from mid-August 2006 until February 2007, as a result of the company's voluntary review of historical stock option and stock grants. The non-statutory options issued in February 2007 to a broad group of key employees were issued with a revised vesting schedule, designed to reward more near-term performance. Such options

were vested as to one third of the shares upon grant, and quarterly thereafter through the second anniversary of the date of grant.

-21-

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*Pricing of stock options.* It has been the committee's policy to set the exercise price of stock options at the then fair market value of our common stock, or higher. As a result of the review by the Audit Committee of the company's historical stock option and stock grants conducted from November 2006 through January 2007, it was determined that there existed flaws in the company's option approval and pricing processes, particularly relating to management's practices during fiscal 2002 and 2003 of awarding grants prior to soliciting the approval of the board or this committee, and the related use of unanimous written consents to approve grants with a date "as of" the date management determined to grant the options, which consents were sometimes circulated after the date of determination. The Audit Committee did not encounter any evidence that would indicate intentional wrongful behaviors with respect to the misapplied option measurement dates. All of the deficiencies observed were, in the Audit Committee's view, attributable to vacillating levels of effectiveness in the company's accounting and documentary control procedures, high turnover of executive leadership, a lack of understanding by company personnel charged with administration of the company's stock option plans of the often complex accounting and tax rules related to stock options, the company's use of spreadsheets rather than more robust stock option software (which software was first used in 2004, but was not fully implemented until March 2005), and insufficient attention by management to the directives of this committee with respect to stock option grant practices.

While the Audit Committee concluded that incorrect measurement dates or fair market value pricing formulas resulted in approximately 100 grants determined to have unrecorded intrinsic value, the Audit Committee did not find evidence demonstrating that stock options were "back-dated" to coincide with low stock prices. Rather, most of the stock options that required adjustment, required such adjustment because the original grant date was determined in the review to have not had sufficient finality to support a measurement date, based on standards articulated by the SEC Office of the Chief Accountant, or the company had determined the exercise price based on the closing price on the day of grant, rather than the day prior to grant, as called for under the company's 1997 Stock Option Plan and 2002 Stock Option Plan. No option grants were determined to have been mispriced after December 2003.

The Audit Committee reported that the problems that led to the measurement date errors had been addressed by the beginning of calendar year 2004, but nonetheless, the committee implemented further refinements to the company's stock option grant procedures in January 2007. For more discussion of the historical review of stock option and stock grant practices, please see the Explanatory Note to the company's Form 10-K filed on January 8, 2007 for the 2006 fiscal year.

*Severance.* A number of our executive officers terminated employment during fiscal 2006. In the absence of contractual provisions providing for the severance payments to be made to such officers, we generally offered each of the former employees severance equal to one month's salary for each two month period of service, or portion thereof, up to six months' salary, in exchange for a general release of all claims. Each of our executive officers who terminated employment during fiscal 2006 accepted an offer of severance on substantially those terms.

### **Principal Executive Officer Compensation**

During fiscal 2006, our company had four persons who performed the duties of principal executive officer. Elwood G. Norris, our Chairman, served in a capacity as co-principal executive officer until September 2006, when he assumed a technical advisory and spokesperson role to our company. Kalani Jones, our former President and Chief Operating Officer, served as co-principal executive officer until his resignation in October 2005. Mr. John Zavoli assumed the position of President and Chief Operating Officer, and co-principal executive officer, in November 2005, until the termination of his employment in August 2006. Thomas R. Brown assumed the position of President and Chief Executive Officer, and sole principal executive officer, in September 2006. The committee had responsibility for determining the compensation of all of Mr. Norris, Mr. Jones, Mr. Zavoli and Mr. Brown.

*Elwood G. Norris.* Mr. Elwood G. Norris currently serves as Chairman of the Board, an executive position. Prior to his appointment as Chief Executive Officer in September 2000, which position Mr. Norris resigned in February 2003, Mr. Norris had been employed by us as Chief Technology Officer pursuant to a three-year employment agreement dated September 1, 1997. The three-year term expired on August 31, 2000, but the agreement remains in effect until one party gives thirty days advance notice of termination to the other. Mr. Norris now serves as Chairman under the term of this agreement. The agreement, as amended by the committee, provides for a base salary of \$16,667 per month. The agreement provides that Mr. Norris will participate in bonus, benefit and other incentives at the discretion of the Board of Directors. We also provide Mr. Norris with an automobile, the lease payments for which are currently approximately \$720 per month. Mr. Norris has agreed not to disclose trade secrets and has agreed to assign certain inventions to us during employment. We are also obligated to pay Mr. Norris certain royalties. See "Certain Transactions" below. Mr. Norris received a non-statutory option to purchase 100,000 shares in May 2006, which option was in recognition of Mr. Norris' performance during fiscal 2005, and was priced at \$4.29, which was 110% of the closing price on the date of grant. This option vests as to 25% of the shares on the first anniversary of the grant date, and quarterly thereafter through the fourth anniversary of the date of grant, subject to Mr. Norris' continuing service to the company.

In light of the transition of Mr. Norris to a technical advisory and spokesperson role at the end of fiscal 2006, the committee did not formally review Mr. Norris's performance for fiscal 2006, and did not award Mr. Norris a bonus for fiscal 2006. No adjustments have been made to Mr. Norris' salary for fiscal 2007. The committee noted that Mr. Norris offered leadership during two transitions of senior management, and that he continued during fiscal 2006 to raise the profile of our company and our products through national press coverage. The committee did determine to grant Mr. Norris a non-statutory option exercisable for 150,000 shares in February 2007, which option was priced at \$4.81, which was 110% of the closing price on the date of grant, and vested as to one third of the shares upon grant, and quarterly thereafter through the second anniversary of the date of grant, subject to Mr. Norris' continuing service to the company.

*Kalani Jones.* Mr. Kalani Jones joined our company in August 2003 as Senior Vice President, Operations. Mr. Jones was promoted to President and Chief Operating Officer in April 2004, following Mr. Jones' performance review for fiscal 2004, his base salary was increased to \$220,000 per year. Such salary was slightly below the 25<sup>th</sup> percentile for the comparable position as reported in the Radford Executive Survey.

Mr. Jones's employment was terminable at-will by us or Mr. Jones for any reason, with or without notice. In October 2005, Mr. Jones's employment with our company terminated. We entered into a separation and release agreement with Mr. Jones. The agreement provided for our one-time payment of \$82,500 to Mr. Jones and our payment of health benefit premiums on Mr. Jones's behalf for a period not to extend beyond February 28, 2006. We also agreed to extend until February 15, 2006 the period of time for which the vested portion of stock options held by Mr. Jones could be exercised. As a result of Mr. Jones' resignation, the committee did not review Mr. Jones' performance for fiscal 2006.

*John R. Zavoli.* In October 2005, the committee recommended to the board for approval a letter agreement with Mr. Zavoli, pursuant to which Mr. Zavoli was appointed as our President and Chief Operating Officer, commencing November 1, 2005. Mr. Zavoli was previously a director of our company, and was a member of this committee from June 2005 until he resigned his committee appointments in connection with entering into the letter agreement. The committee informally authorized Mr. Norris to negotiate Mr. Zavoli's compensation with Mr. Zavoli, and the recommendation of Mr. Norris was approved by the committee (without Mr. Zavoli present) with a recommendation to the full board for approval. The level of compensation and other terms of the employment agreement were determined in arms' length negotiations between Mr. Norris and Mr. Zavoli, and the committee did not rely upon benchmark data in approving the level of Mr. Zavoli's compensation. The letter agreement provided for an annual base salary of \$250,000 and eligibility for an annual bonus, as recommended by this committee and approved by the board of directors. In addition, Mr. Zavoli received a non-statutory option to purchase 100,000 shares of our common stock on his start date of November 1, 2005. Mr. Zavoli's employment was not for a specified period or term of employment



and was terminable at-will by us or by Mr. Zavoli for any reason, with or without notice. In August 2006, Mr. Zavoli's employment arrangement with the company terminated. Mr. Zavoli's annual base salary at the time of termination was \$250,000 and he was entitled to severance in the form of post-termination salary continuation and payment by our company of the premiums for extension of benefits under COBRA for a number of months based on his number of months of service, conditioned on his execution of a general release of all known and unknown claims against our company, and the continued effectiveness of such release beyond any statutory revocation period. In September 2006, Mr. Zavoli resigned from his position as a member of our board of directors and entered into a separation and release agreement with our company providing: (a) payments of \$125,000, representing six months of base salary, and (b) payment of health benefit premiums on Mr. Zavoli's behalf for a period not to extend beyond February 28, 2007 estimated at \$6,210. In addition, the separation and release agreement contained Mr. Zavoli's general release of all claims against our company. As a result of the termination of Mr. Zavoli's employment arrangement, the committee did not review Mr. Zavoli's performance for fiscal 2006.

*Thomas R. Brown.* In August 2006, the committee recommended to the board for approval a letter agreement to be entered into with Mr. Brown pursuant to which he was appointed as our President and Chief Executive Officer commencing September 5, 2006. Mr. Brown was also appointed as Interim Chief Financial Officer on September 19, 2006. The terms of Mr. Brown's employment did not change in connection with his appointment as Interim Chief Financial Officer. The committee informally authorized Mr. Norris to negotiate Mr. Brown's compensation with Mr. Brown, and the recommendation of Mr. Norris was approved by the committee (without Mr. Brown present) with a recommendation to the full board for approval. The level of compensation and other terms of the employment agreement were determined in arms' length negotiations between Mr. Norris and Mr. Brown, and the committee did not rely upon benchmark data in approving the level of Mr. Brown's compensation. The letter agreement provides for a base salary of \$250,000 per year. This amount was the same amount previously payable to Mr. Zavoli. In connection with his employment, Mr. Brown received a non-statutory option to purchase 200,000 shares of common stock under our 2005 Equity Incentive Plan with an exercise price \$3.33 per share, the closing price of our common stock on the start date as reported on the Nasdaq Capital Market. Mr. Brown is eligible for an annual bonus with respect to fiscal years beginning fiscal 2007 as recommended by the committee and approved by the board, to be based in part on his achievement of detailed annual goals established by the committee. Mr. Brown's bonus for fiscal 2007 will be based upon the bonus plan described above under "Long-term incentives." In the event that Mr. Brown's employment is terminated for any reason other than cause, or if he resigns for good reason, he will be entitled to severance equal to one month's salary for each two month period of service, or portion thereof, up to six months' salary. He will also be entitled to continuation of his company-provided health and dental benefits for the same period.

### **The Committee's Conclusion**

The committee has determined that the aggregate compensation of the executive officers during fiscal 2006, including the compensation to persons who served as principal executive officer during fiscal 2006, was reasonable and not excessive.

### **Section 162(m) of the Internal Revenue Code**

Under Section 162(m) of the Internal Revenue Code, compensation payments in excess of \$1 million to each person who served as Chief Executive Officer at the end of a taxable year, and to each of the other most highly compensated executive officers whose compensation must be disclosed in SEC filings, are subject to a limitation of \$1 million on the amount we may deduct as an ordinary business expense. Certain performance-based compensation is not subject to the limitation on deductibility. The total taxable compensation to each employee subject to Section 162(m) during the taxable year ended September 30, 2006 was below \$1 million.

We granted stock options to persons subject to Section 162(m) in a manner designed to qualify such stock options as performance-based compensation. However, from June 2004 to April 2005, we issued non-qualified stock options not approved by stockholders to certain persons, none of whom are currently executive officers subject to Section 162(m), but certain of whom could in the future become subject to Section 162(m), in each case as an inducement material to employment. In addition, as described above under "Pricing of stock options," approximately 100 historical option grants were determined to have been priced with an exercise price below the fair market value on the accounting measurement date. To the extent that any of these options are exercised by persons who are subject to Section 162(m) on the date of exercise, the amount of the deduction that we would otherwise be entitled to may be limited to the extent the ordinary income recognized by the subject employee upon such exercise, together with all other compensation in a given taxable year, exceeds \$1 million. The committee has to date qualified as performance-based compensation all stock option grants under the 2005 Equity Incentive Plan, and intends to continue to do so. However, the committee may in its discretion make other awards to existing or potential future employees subject to Section 162(m) which do not qualify as performance-based compensation.



The committee believes that any application of Section 162(m) to limit deductibility of executive compensation is unlikely to have a material effect on our financial condition or results of operations, as a result of the company's net operating loss carry-forwards, which were approximately \$54,473,000 at September 30, 2006, and which expire through 2027. However, certain amounts of these carry-forwards are subject to significant limitations under the Internal Revenue Code of 1986, as amended, and the committee notes that a valuation allowance has been provided in our financial statements to offset the net deferred tax asset associated with such loss carry-forwards, as management has determined that it is more likely than not that the deferred tax asset will not be realized.

#### COMPENSATION COMMITTEE

Daniel Hunter (Chairman)

Raymond C. Smith

Laura M. Clague (Ms. Clague was not a member of the Compensation Committee during fiscal 2006)

-25-

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## REPORT OF THE AUDIT COMMITTEE

*Introductory Note:* The following report is not deemed to be incorporated by reference by any general statement incorporating by reference this Proxy Statement into any filing under the Securities Act or under the Exchange Act, except to the extent that we specifically incorporate this information by reference, and shall not otherwise be deemed soliciting material or filed under such acts.

The following is the report of the Audit Committee with respect to our audited financial statements for the fiscal year ended September 30, 2006.

The Audit Committee has reviewed and discussed the audited financial statements of American Technology Corporation with management. The Audit Committee has discussed with Swenson Advisors, LLP, our independent registered public accounting firm, the matters required to be discussed by Statement of Auditing Standards No. 61, *Communication with Audit Committees*, which includes, among other items, matters related to the conduct of the audit of our financial statements. The Audit Committee has also received written disclosures and the letter from Swenson Advisors, LLP required by Independence Standards Board Standard No. 1, which relates to the accounting firm's independence from our company, and has discussed with Swenson Advisors, LLP its independence from our company.

The Audit Committee acts pursuant to the Audit Committee Charter adopted by the Board of Directors. The Audit Committee Charter was amended and restated in April 2004. Each of the members of the Audit Committee qualifies as an independent director under the current listing standards of the NASDAQ Stock Market. The Charter of the Audit Committee is attached as Annex 1 to this proxy statement.

Based on the review and discussions referred to above, the Audit Committee recommended to the Board of Directors that audited financial statements be included in our company's Annual Report on Form 10-K for the fiscal year ended September 30, 2006.

### AUDIT COMMITTEE

Daniel Hunter (Chairman)

Raymond Smith

Laura M. Clague (Ms. Clague was not a member of the Audit Committee during fiscal 2006)

## COMPANY STOCK PRICE PERFORMANCE

*Introductory Note:* The stock price performance graph below is required by the SEC and will not be deemed to be incorporated by reference by any general statement incorporating by reference this Proxy Statement into any filing under the Securities Act, or under the Exchange Act, except to the extent that we specifically incorporate this information by reference, and shall not otherwise be deemed soliciting material or filed under such laws.

The following graph compares the five-year cumulative total return on our common stock to the total returns of 1) NASDAQ Stock Market and 2) NASDAQ Stock - Electronic & Electrical Equipment & Components, excluding Computer Equipment. This comparison assumes in each case that \$100 was invested on September 30, 2001 and all dividends were reinvested. Our fiscal year ends on September 30.

## CERTAIN TRANSACTIONS

Under the terms of an Assignment of Technology Agreement dated March 2, 1993 and an Addendum Agreement dated December 2, 1996 we are obligated to pay Elwood G. Norris, our Chairman, a 2% royalty on net sales from certain of our technologies, of which only HSS is a current offering of our company. The royalty obligation continues until at least March 1, 2007, and for any longer period during which we sell products or license technologies subject to any patent assigned to us by Mr. Norris. No royalties were paid or recorded under this agreement in the fiscal years ended September 30, 2006, 2005 or 2004, as these royalties were immaterial and were waived by Mr. Norris. We may owe royalties in future periods based on actual sales or technology revenues.

Mark Norris, the son of Elwood G. Norris, is a full-time non-executive employee of our company. In his role as a Mechanical Engineer, Mark Norris was paid \$103,336 in salary for the fiscal year ended September 30, 2006. No other family member of any executive officer, director or 5% stockholder received compensation of more than \$60,000 during the year ended September 30, 2006.

On August 7, 2006, we closed an institutional financing and issued 4,870,512 shares of our common stock at a purchase price of \$1.95 per share and warrants exercisable for an aggregate of 1,948,205 shares of common stock at an exercise price of \$2.67 per share. The warrants are exercisable from February 7, 2007 until August 6, 2010. Institutional investors included Special Situations Fund III QP, L.P., Special Situations Fund III L.P., Special Situations Private Equity Fund, L.P., Special Situations Technology Fund, L.P., and Special Situations Technology Fund II, L.P., collectively purchasing an aggregate of 2,051,282 shares and warrants exercisable for an aggregate of 820,542 shares. Based on a Schedule 13G filing on February 14, 2006, Austin W. Marxe and David M. Greenhouse beneficially owned more than five percent of our outstanding common stock prior to the financing and are controlling principals of the general partners and investment advisors of the Special Situation Funds. See Note 3 to the ownership table in "Security Ownership of Certain Beneficial Owners and Management" above for additional information and more current joint ownership information of Mr. Marxe and Mr. Greenhouse through the Special Situation Funds.

The August 2006 financing triggered certain anti-dilution provisions of prior warrants including warrants to purchase an aggregate of 179,302 shares held by certain of the Special Situations funds. The exercise price of the warrants held by the Special Situation Funds was adjusted from \$6.36 to \$5.44 and the shares issuable upon exercise of the warrants increased from 179,302 to 209,620 as a result of the anti-dilution adjustment. The warrant expiration date is unchanged at July 18, 2009.

In connection with the August institutional financing described above, anti-dilution provisions also triggered adjusting the exercise price of 617,500 warrants expiring September 30, 2006 from \$2.00 per share to \$1.95 per share. However, the repricing of these warrants did not apply to the warrant for 125,000 shares held by a family trust of Mr. Norris, our Chairman, as a result of a waiver executed by the trust. This warrant was granted in 2001 in connection with a private placement and was exercised on September 20, 2006 for cash by Mr. Norris' family trust.

**PROPOSAL THREE**  
**APPROVAL OF AMENDMENTS TO THE COMPANY'S 2005 EQUITY INCENTIVE PLAN**

In March 2007, the Compensation Committee approved amendments to our 2005 Equity Incentive Plan, which we refer to as the 2005 Plan, in the form attached hereto as Annex 4, certain provisions of which are subject to stockholder approval. Stockholders are being asked to approve an increase the maximum plan reserve to 5,062,501 shares, which includes the original maximum plus reserve of 3,312,501 shares, plus 1,750,000 new shares, and to increase the limit of the number of shares that may be granted to one awardee within any calendar year under the 2005 Plan to 1,000,000 shares. Currently, the per awardee limit is 250,000 shares within any calendar year, except that in connection with his or her initial service, an awardee may be granted awards covering up to an additional 500,000 shares. The proposed 1,000,000 shares limit would apply to initial service and to continuing service.

The affirmative vote of a majority of the votes cast at the meeting, either in person or by proxy, is required to approve the amendments to the 2005 Plan. Abstentions will be counted toward the tabulation of votes cast on this proposal for the purpose of determining a quorum and will have the same effect as negative votes. Broker non-votes are counted towards a quorum, but are not counted for any purpose in determining whether this proposal has been approved.

We have qualified this plan under the California Corporate Securities Law of 1986. In reviewing qualification applications, the California Commissioner of Corporations will consider regulations which require that an employee, director and consultant option or purchase plan be approved by stockholders holding a majority of the outstanding shares entitled to vote. For such purposes, both abstentions and broker non-votes have the same effect as negative votes. Accordingly, while we will deem the amendments to 2005 Plan approved by the stockholders if the number votes cast in favor exceeds the number of votes cast against, as set forth in the prior paragraph, we may not be able to qualify the additional shares reserved under the 2005 Plan pursuant to these amendments under the California Corporate Securities Law of 1986 without the higher threshold for approval discussed above. If we do not obtain the affirmative vote of stockholders holding a majority of shares entitled to vote, and if the California Commissioner of

Corporations will not deviate from its guidelines when we apply for qualification, we will be able to issue additional securities under the 2005 Plan only pursuant to an available exemption from qualification requirements.

-28-

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**Our Board of Directors Recommends a vote IN FAVOR of Proposal Three**

The essential features of the 2005 Plan are outlined below:

*General*

Our Board of Directors approved the 2005 Plan on January 27, 2005 and ratified certain technical changes to the 2005 Plan on March 22, 2005. The 2005 Plan became effective on April 28, 2005, the effective date of stockholder approval of the plan at our annual meeting of stockholders, and was subsequently amended on August 5, 2005. These amendments did not require stockholder approval. Certain amendments made in March 2007 also do not require stockholder approval, and are presently effective.

*Background and Purpose of the 2005 Plan*

The purpose of the 2005 Plan is to encourage ownership in our company by key personnel, whose long-term service is considered essential to our continued progress, thereby linking these employees directly to stockholder interests through increased stock ownership.

As of March 12, 2007, no shares had been issued under the 2005 Plan, and options to purchase approximately 1,692,700 shares at exercise prices ranging from \$2.60 to 5.57 per share were outstanding. Excluding the increase of 1,750,000 shares for which stockholder approval is being sought pursuant to this Proposal Three approximately 705,478 shares were available for future grant under the 2005 Plan.

*Eligible Participants*

Awards under the 2005 Plan may be granted to any of our employees, directors, or consultants or those of our affiliates. As of March 12, 2007, there were approximately 42 full-time employees, 3 non-employee directors, and 2 consultants who would be eligible to participate. An incentive stock option may be granted under the 2005 Plan only to a person who, at the time of the grant, is an employee of us or a related corporation.

*Number of Shares of Common Stock Available Under the 2005 Plan*

The initial reserve for the 2005 Plan was a maximum of 3,312,501 shares, which maximum included a total of 1,500,000 new shares of our common stock, plus up to 1,812,501 shares that were, upon Board approval of the 2005 Plan, available under our 2002 Stock Option Plan, which we refer to as the 2002 Plan, or were subject to then outstanding options under the 2002 Plan or the 1997 Stock Option Plan, which we refer to as the 1997 Plan. These older plan shares were included in the maximum reserve because the 2002 Plan was terminated with respect to the availability of future option grants after approval of the 2005 Plan by the stockholders, and the 2002 Plan included in its reserve shares that were subject to outstanding options under the 1997 Plan. The actual reserve under the 2005 Plan currently consists of the 1,500,000 new shares, shares of our common stock available for issuance under the 2002 Plan as of the original date of approval of the 2005 Plan by the stockholders, and shares of our common stock that are issuable upon exercise of options granted pursuant to the 1997 Plan or the 2002 Plan that expire or become unexercisable for any reason without having been exercised in full after approval by the stockholders of the 2005 Plan. The reserve under the 2005 Plan is reduced by options under the 1997 Plan, the 2002 Plan or th