

APPLIED SIGNAL TECHNOLOGY INC  
Form 10-K  
January 29, 2007

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

**Form 10-K**

(Mark One)

☒ Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

**For the Fiscal Year Ended October 31, 2006**

or

☐ Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the Transition Period from \_\_\_\_\_ to \_\_\_\_\_.

Commission file number 0-21236

**Applied Signal Technology, Inc.**  
(Exact name of registrant as specified in its charter)

**California**  
(State or other jurisdiction of  
incorporation or organization)

**77-0015491**  
(I.R.S. Employer  
Identification No.)

**400 West California Ave., Sunnyvale, CA 94086**  
(Address of principal executive offices)

**(408) 749-1888**  
(Registrant's telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act: Not Applicable.

Securities registered pursuant to Section 12(g) of the Act: Common Stock, without par value.

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

	ü
<b>Yes</b>	<b>No</b>

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act.

	ü
<b>Yes</b>	<b>No</b>

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

	ü
<b>Yes</b>	<b>No</b>

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ☐

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act (check one):

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ü

**Large accelerated filer**

**Accelerated filer**

**Non-accelerated filer**

Indicate by check mark whether the registrant is a shell company (as defined by Rule 12b-2 of the Act).

ü  
**Yes**      **No**

Aggregate market value of the voting common stock held by non-affiliates of the registrant:

Common Stock, without par value – \$200,768,105 as of April 28, 2006, based on the closing price on such date for the registrant's common stock reported by the NASDAQ National Market System. For purposes of this disclosure, shares of common stock held by persons who held more than 5% of the outstanding shares of common stock and shares held by officers and directors of the registrant have been excluded in that such persons may be deemed to be affiliates. The determination of affiliate status is not necessarily a conclusive determination for other purposes.

Number of shares of registrant's common stock outstanding:

Common Stock, without par value – 11,922,103 shares as of October 31, 2006.

Documents Incorporated by Reference

The registrant has incorporated by reference into Part II, Item 5 and Part III of this Form 10-K portions of its proxy statement for the registrant's Annual Meeting of Shareholders to be held on March 14, 2007.

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## **Explanatory Note**

In this annual report on Form 10-K, we are restating the consolidated balance sheet as of October 31, 2005, and the statements of operations, shareholders' equity, and cash flows for fiscal year 2004, as well as the statements of shareholder's equity for fiscal year 2005. We have not amended our previously filed annual reports on Form 10-K for the periods affected by this restatement. See "Item 1A: Risk Factors," "Item 6. Selected Consolidated Financial Data," "Item 7: Management's Discussion and Analysis of Financial Condition and Results of Operations," and "Note 2: Restatement of Financial Statements" in "Notes to Consolidated Financial Statements" for more detailed information regarding the restatement of our balance sheet and statement of shareholders' equity for the fiscal year ended October 31, 2005, statements of operations, shareholders' equity, and cash flows for the year ended October 31, 2004, and the changes to the financial statements for the years ended October 31, 2000, October 31, 2001, October 31, 2002, October 31, 2003, and October 31, 2004.

During fiscal year 2006, in connection with our review of our financial results for the fiscal year ended October 31, 2006, we commenced a voluntary internal review of our historic stock option grant practices and procedures and related accounting. We reviewed all of our grants of stock options from the date of our initial public offering in March 1993 to October 31, 2006. As a result of our review, we concluded that we had not properly measured compensation cost for an annual option grant to non-officer employees on November 18, 1999, because the number of shares certain non-officer individual employees were entitled to receive was not determined until after the original measurement date. We also concluded that we used improper measurement dates for certain grants to newly hired non-officer employees because the measurement date utilized predated the actual commencement of employment.

In circumstances in which the prices of our shares at the originally stated grant dates were lower than the prices on the actual measurement dates, we concluded that we should have recognized additional stock-based compensation expense associated with the November 18, 1999, option grant to non-officer employees for fiscal years 2000 and 2001 that was not accounted for in our previously issued financial statements. In addition, we determined we should have recorded immaterial stock compensation expense associated with certain non-officer new hire stock option grants that were granted between fiscal years 2000 and 2004. Therefore, the Audit Committee, after consultation with management, concluded that our previously filed audited financial statements for fiscal years ended October 31, 2000, through October 31, 2005, should be restated as described above.

Based upon the results of our review, we recorded additional stock-based compensation, and related payroll taxes, with respect to stock option grants to non-officer employees and non-officer new hires, for which we determined that the measurement dates were in error. These additional operating expenses caused us to record adjustments to income tax expense, deferred tax assets, income taxes payable, and additional paid-in capital. The cumulative reduction to retained earnings through the beginning of fiscal year 2005 was approximately \$1,121,000. This adjustment was offset by a cumulative adjustment to additional paid-in capital of approximately \$1,318,000, resulting in a cumulative increase to total shareholder's equity of approximately \$197,000. The cumulative adjustment to our total assets and total liabilities was approximately \$298,000 and \$101,000, respectively.

### **Judgments and Interpretations on Restatement Values**

In calculating the amount of incremental stock-based compensation expense to record, we had to make certain interpretations and assumptions and draw certain conclusions from and regarding the internal review findings. There is the risk that the interpretations and assumptions we made could be disputed by others after the fact or that we did not draw the correct conclusions from the findings. All of these risks are particularly acute where there was incomplete documentation. Where we had incomplete documentation, we considered the guidance provided by the Office of the Chief Accountant of the SEC, pursuant to a letter dated September 19, 2006 (the Chief Accountant's letter). Specifically, we used all reasonably available relevant information to form reasonable conclusions as to the most likely option granting actions that occurred and the dates

on which such actions occurred in determining the parameters of the restatement.

Accordingly, this Form 10-K also reflects the restatement of:

- Selected Consolidated Financial Data for the fiscal years ended October 31, 2000, through 2005 in Item 6
- Management's Discussion and Analysis of Financial Condition and Results of Operations in Item 7 for the years ended October 31, 2004, and 2005

Previously filed annual reports on Form 10-K and quarterly reports on Form 10-Q affected by the restatements have not been amended and, as such, should not be relied upon. On January 16, 2007, we filed a Form 8-K announcing that, although we had not yet concluded which specific periods may require restatement, the Audit Committee of our Board had concluded that certain of our previously issued financial statements should no longer be relied upon.

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## Part I

### Item 1: Business

This annual report on Form 10-K contains forward-looking statements made pursuant to the provisions of Section 21E of the Securities Exchange Act of 1934. These forward-looking statements are based on management's current expectations and beliefs, including estimates and projections about our industry. Forward-looking statements may be identified by the use of terms such as "anticipates," "expects," "intends," "plans," "seeks," "estimates," "believes," and similar expressions, although some forward-looking statements are expressed differently. Statements concerning financial position, business strategy, and plans or objectives for future operations are forward-looking statements. These statements are not guarantees of future performance, are subject to certain risks, uncertainties, and assumptions that are difficult to predict, and may cause actual results to differ materially from management's current expectations. Such risks and uncertainties include those set forth under "Item 1A: Risk Factors" and "Item 7: Management's Discussion and Analysis of Financial Condition and Results of Operations." The forward-looking statements in this report speak only as of the time they are made and do not necessarily reflect management's outlook at any other point in time. We undertake no obligation to update publicly any forward-looking statements, whether as a result of new information, future events, or for any other reason. However, readers should carefully review the risk factors set forth in other reports or documents we file from time to time with the Securities and Exchange Commission (SEC) after the date of the Annual Report. These SEC filings, as well as our latest annual report, can be obtained through our website at [www.appsig.com](http://www.appsig.com). In addition, hard copies can be obtained free of charge through our investor relations department.

#### Description of the Business

Applied Signal Technology, Inc. (AST) provides advanced digital signal processing products, systems, and services in support of intelligence, surveillance, and reconnaissance (ISR) for global security. We provide processing of both man-made and naturally-occurring signals. The processing of man-made signals includes communications intelligence (COMINT) and electronic intelligence (ELINT). The processing of natural signatures includes the use of sonar, radar, magnetic and chemical sensors to detect changes in the environmental phenomenology. Our primary customer is the United States Government. We develop and manufacture equipment for both the collection and processing of signals.

COMINT derives intelligence from telecommunications signals. Our COMINT signal collection equipment consists of sophisticated receivers that scan through potentially thousands of cellular telephone, microwave, ship-to-shore, and military transmissions in the radio frequency (RF) spectrum with the goal of collecting certain specific signals. Our COMINT signal processing equipment uses advanced software and hardware to evaluate characteristics of the collected signals and selects those most likely to contain relevant information. At inception, our efforts were primarily focused on COMINT processing equipment. Over time, we have broadened our scope to add specialized collection equipment and complete signal processing systems and related services.

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

Sensor signal processing observes changes in physical phenomena that can provide an indication of activities of concern to global security. Examples of these phenomena are detection of chemicals that might be used for explosive devices or the detection of sub-terrain ferrous materials that might indicate an underground facility for weapon manufacturing. Our sensor processing equipment provides automatic detection of physical abnormalities in both marine and terrestrial environments.

Substantially all of our revenues are from contracts with the United States Government, its agencies, or prime contractors to the United States Government.

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We are incorporated in California. Our principal executive offices are located at 400 West California Ave., Sunnyvale, CA, 94086, and our telephone number at that address is (408) 749-1888. Our web site address is [www.appsig.com](http://www.appsig.com). The information posted on our website is not incorporated into this annual report. However, investors can obtain a copy of this annual report on Form 10-K, our quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to such reports filed or furnished with the SEC, as well as a copy of our Code of Ethics, on our website free of charge.

### Communications Intelligence (COMINT)

Accurate and comprehensive information regarding foreign affairs and developments affecting international security has become increasingly important to the United States Government. The political instability in certain regions such as the Middle East, Eastern Europe, Africa, and Central and South America and the ongoing counterterrorism campaign have heightened the United States Government's need to be able to monitor activities in foreign countries. In order to obtain information about activities within foreign countries, the United States Government gathers and analyzes telecommunications signals emanating from those countries.

The ever-increasing commercial development of telecommunications equipment has led to a significant increase in the overall quantity of information communicated and an increase in the density of signals transmitted throughout the radio frequency (RF) spectrum. This increase can be seen in the proliferation of facsimile, cellular, and digital signal telecommunications equipment and in the global information network (such as the Internet) in recent years, resulting in a significant increase in the amount of information being communicated. Consequently, the need to develop COMINT equipment capable of collecting and processing an increasing quantity of signals, as well as new types of signals, has grown significantly.

We devote significant resources toward understanding the United States Government's COMINT goals, capabilities, and perceived future needs. We obtain information about these signal reconnaissance needs through frequent marketing contact between our employees and technical and contracting officials of the United States Government. In addition, we invest in research and development (R&D) activities that we anticipate will enable us to develop signal reconnaissance equipment that meets the future needs of the United States Government.

Our COMINT products can be used, with or without further modification, to satisfy requirements of a variety of customers. Our products can be deployed readily in a wide variety of circumstances to meet current United States Government signal reconnaissance requirements.

In addition, we believe that the United States Government is continuing to increase funding for counterterrorism. Counterterrorism is focused on individuals and groups of individuals, and relies heavily on intelligence gathering. A key source for intelligence is COMINT. We are a resource to the United States Government, providing COMINT products, systems, and services.

### Electronic Intelligence (ELINT)

The same countries that have political instability and terrorist activities are modifying older Soviet-developed weapons systems as well as developing new weapons systems. Accordingly, the United States Government must invest in new ELINT technologies to gather intelligence about these weapons systems. There is also a need to advance ELINT technology to provide battlefield mapping and force protection against these new weapons systems.

We are investing to develop a state-of-the-art ELINT processor that will provide information concerning the characterization and location of these new weapons systems. We expect that this investment will result in a product that will also be applicable to unmanned aerial vehicles, which we believe will be the platform of choice for future ELINT missions.

### Sensor Processing

In the current counterterrorism campaign, the United States Government has determined that the collection of signature information is very important in aiding the detection and location of terrorist activities. We believe that sensor detection of chemicals that might be used for explosives or ferrous materials that might indicate installations of improvised explosive devices is a high-priority information source to the United States Government.

Our sensor processing products can aid anti-submarine warfare, as well as mine countermeasures. We also have products that can detect land-based mines and improvised explosive devices (IEDs).

Homeland security requires a robust system that quickly conducts covert or overt inspection of containers, vehicles, packages, and facilities anywhere in the world, on land or sea, by using tools that reach beyond the fixed site border security systems. In particular, United States security forces need to have a portable capability to "see" through walls and other barriers to non-intrusively identify dangerous materials on the other side.

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To address this need, Applied Signal Technology, united with industry and government partners, is developing neu-VISION™—a portable neutron imaging and material identification system designed to provide through-barrier detection and classification of explosives, chemical agents, radiological or nuclear materials, and other hazardous materials in a variety of operational settings. The innovative neutron imaging technology serves an important role in the nation's integrated security capability with its unique combination of barrier penetration, three-dimensional representation, material identification, and operational flexibility. We have obtained a license to operate neutron-imaging equipment at our non-intrusive inspection test facility in Torrance, California.

### Segments

We have reviewed our business operations and determined that we operate in a single homogeneous business segment. We sell similar products and services with similar economic characteristics to similar classes of customers, primarily to the United States Government, its agencies, or prime contractors for the United States Government. Our technologies and the operations of our divisions are highly integrated. Revenues and costs are reviewed monthly by management on an individual contract basis as a single business segment.

### Strategy

Our objective is to anticipate the needs of the global security marketplace and to invest in research and development so we can provide solutions to ISR needs before our competitors. In some cases, our solution is to develop equipment or services that address new telecommunications technologies or detection of new phenomena of importance. In other cases, our solution is to develop equipment that offers smaller size, lower power consumption, and lower cost than potentially competitive products. Our strategy to accomplish these objectives focuses on the following elements.

**Anticipate marketplace needs.** We devote significant resources in order to anticipate future global security needs. We monitor technological and commercial advances in telecommunications as well as trends in terrorist activities to identify what we believe are new opportunities for the development of our products. We obtain information about marketplace needs through frequent contact with technical and contracting officials of pertinent government agencies within the intelligence community.

Many times, the United States Government grants sole-source contracts when a single contractor is deemed to have expertise or technology that is superior to that of competing contractors. Since our inception, a significant portion of our revenues has been from sole-source contracts.

**Invest in research and development.** We invest in research and development that we believe will enable us to develop equipment and services that will satisfy the future global security needs of our customers. This, in turn, often enables us to introduce products that meet marketplace demands before our competitors. An important aspect of our R&D efforts is the understanding of information sources that could enhance global security in order to anticipate the future signal processing needs of our customers. Not only does this allow us to direct R&D engineering efforts to produce solutions promptly once a customer expresses a requirement, but it often allows us to educate the customer about potential requirements and simultaneously present a conceptual solution to those requirements.

**Develop flexible products.** We develop products that can be used as originally designed, or with further customization, to satisfy the needs of a variety of customers. We use prior product development efforts to offer customers cost-effective solutions and to offer these solutions promptly.

**Develop highly integrated products.** We design our products to use advanced circuitry and highly integrated components. This enables us to offer products that are smaller, consume less power, and cost customers less when multiple units are built than equipment of similar functionality that uses fewer advanced designs and materials. The lower cost of many of our products appeals to customers with budget constraints, and the small size and low power consumption of many of our products appeal to customers with physical installation constraints.

**Focus on signal processing.** Since inception, we have focused our attention on developing signal processing equipment and services. We believe that there have been and will continue to be opportunities to develop specialized signal processing equipment and services to satisfy emerging technological requirements.

**Increase business with existing customers and broaden customer base.** We believe that our current customers offer opportunities for sales growth through sales of additional units of developed products and through contracts to develop new products. Accordingly, we direct much of our marketing efforts toward these customers in order to increase our penetration of these markets. Additionally, we continue to try to broaden our customer base by increasing marketing efforts toward military signal reconnaissance.

### Products

Communications Intelligence (COMINT) Products

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Our COMINT products consist of signal collection and processing equipment that use software and hardware that we developed over many years. This software and hardware enables our processing equipment to evaluate large numbers of radio frequency signals and to select the relatively small portion that contains information likely to be useful to the United States Government. We offer a variety of COMINT products that can be categorized as follows.

***Voice grade channel processors.*** These processors are designed to process voice grade channels (VGCs), which carry audio and other signals. The standard telecommunication systems used throughout the world put a large number of VGCs on a single carrier channel to increase the number of signals that can be transmitted at a particular frequency. Our VGC processors can scan thousands of signals in less than one second, evaluate their characteristics, and use sophisticated processing technology to detect and record relevant data that is then analyzed by United States Government personnel. Our VGC processors currently range in price from approximately \$3,000 to approximately \$700,000.

***Wideband processors.*** These processors “clean” telecommunication signals for further processing by VGC processors by adjusting for signal distortions that commonly occur during transmission. The two primary types of distortions that these processors correct are multipath interference (caused by the reception of a signal and its reflections) and co-channel interference (caused by the reception of multiple interfering signals). Commercial telecommunication companies overcome these distortions with careful alignment and tuning that requires interruption of the telecommunication signals. Our wideband processors perform this alignment independently and automatically by using proprietary adaptive algorithms that let the processors “learn” how to adjust their parameters to process the incoming signals. One of our wideband products processes signals that carry thousands of VGCs in a globally used digital format that is particularly susceptible to distortions. Our wideband processors currently range in price from approximately \$8,000 to approximately \$90,000.

***Collection products.*** We offer a limited number of signal collection products designed to complement some of our processing products. Our collection products include a low-cost, small receiver that collects very complex signaling formats, and a receiver that optimizes multiple antenna inputs to overcome co-channel interference and certain forms of multi-path interference. Our collection products currently range in price from approximately \$20,000 to approximately \$40,000.

***Software products.*** Software products are based upon the use of commercial off-the-shelf hardware processors. With current state-of-the-art computer and component technologies (for example, field-programmable gate arrays, Pentium processors, G4 processors), global security requirements can often be met by utilizing off-the-shelf “compute engines.” We develop our software products so the signal processing can be performed on these engines when applicable. Our software products, utilizing our proprietary licenses, range in price from approximately \$2,000 to approximately \$100,000.

### Sensor Processing Products

Our sensor processing products consist of advanced digital signal processing hardware and software. These products automatically process the results of physical phenomena sensors to detect abnormalities of interest. These products can be categorized as follows.

***Marine processors.*** These processors are designed to detect abnormalities in the marine environment such as the presence of a submarine, mines tethered to the ocean floor, and terrorist activities such as attempts to destruct a telecommunication cable on the ocean floor. These processors consist of active sensing such as synthetic aperture sonar and radar detection of periscopes as well as passive sensing such as magnetic detection of submarines. These processors can range in price from approximately \$200,000 to approximately \$4,000,000.

***Terrestrial processors.*** These processors are designed to detect terrestrial abnormalities such as buried land mines, IEDs, and underground structures. These processors can be active sensors such as associated particle imaging or passive sensors such as electro-magnetic sensing. These processors can range in price from approximately \$500,000 to approximately \$2,000,000.

### Systems

***Systems development.*** We also develop and deliver entire systems in situations where the capabilities of our products formulate the majority of the system capability. These systems include our custom developed system software, and the integration of the appropriate compilation of our products as well as, at times, the integration of other vendors’ products. Pricing for processing systems can vary widely depending on systems requirements and may range from approximately \$300,000 to tens of millions of dollars.

***Systems integration.*** In recent years, we have applied our expertise to integrate signal processing systems comprised mainly of other vendors’ products. These system integration efforts are usually performed at a customer’s facility or site (many times in foreign countries). These contracts may include the development of system software, the physical integration of other vendors’ products, and the final system testing to verify performance. These contracts may require us to perform on-going maintenance and mission management efforts.

***ELINT systems.*** We are currently investing to develop an airborne ELINT processing system capable of being installed in either manned or unmanned aerial vehicles. This system will be capable of identifying modern weapons systems of foreign countries and precisely geo-locating

their position in the battlefield.

## Services

We perform engineering services for current operational systems. Examples of these services are: 1) evaluation of current performance, 2) engineering improvements for performance enhancement, 3) evaluation of signals being processed to develop system operation techniques that can improve the intelligence gathering, 4) on-going mission management of a system, and 5) customer training in the usage of our standard products. Contracts for these services range in price up to several hundred thousand dollars.

## Customers, Contracts, and Marketing

### Customers

Since our inception, purchases by the United States Government have accounted for almost all of our revenues. These purchases occur in two ways: through contracts directly with the government and subcontracts to prime contractors. Direct contracts with the United States Government accounted for approximately 60%, 67%, and 63% of revenues in fiscal years 2006, 2005, and 2004, respectively. The subcontracts under which we supply products or services to prime contractors that have contracts with the United States Government accounted for approximately 37%, 28%, and 34% of revenues in fiscal years 2006, 2005, and 2004, respectively.

Our United States Government customers consist of military and intelligence agencies that have signal reconnaissance needs. Within our primary customer agencies, we have contracts with approximately 40 different offices, each with separate budgets and contracting authority.

The following table identifies the source of our revenues for fiscal years 2006, 2005, and 2004 by customer type.

	FY06	FY05	FY04
Intelligence agencies	74%	72%	80%
Military	23%	23%	17%
Foreign	1%	2%	2%
Commercial	2%	3%	1%
	-----	-----	-----
	100%	100%	100%
	=====	=====	=====

Contracts with all offices of two intelligence agencies accounted for approximately 24% and 46% of revenues in fiscal year 2006; approximately 28% and 44% of revenues in fiscal year 2005; and approximately 26% and 54% of revenues in fiscal year 2004, respectively. Contracts with one branch of the military accounted for approximately 17%, 21%, and 15% of revenues in fiscal years 2006, 2005, and 2004, respectively.

### Contracts

Most of our business is conducted under contracts that include United States Government security requirements. Our contracts with United States Government agencies are of two types, as described below.

Sole-source contracts are awarded by the United States Government when a single contractor is deemed to have an expertise or technology that is superior to that of competing contractors. Potential suppliers compete informally for sole-source contracts through R&D investment and marketing efforts. This competition requires a contractor to identify the United States Government's requirements early and invest in developing potential solutions so that the contractor can demonstrate a distinguishing expertise or technology promptly after the United States Government has identified a requirement. Sole-source contracts are awarded without a formal competition.

Competitive-bid contracts are awarded based on formal proposal evaluation criteria established by the procuring agency. Interested contractors prepare a bid and proposal in response to the agency's request. A bid and proposal is usually prepared in a short time period (for example, 45 days) in response to a deadline, and requires the extensive involvement of numerous technical and administrative personnel. Competitive-bid contracts are awarded after a formal bid and proposal competition among suppliers.

The following table identifies the allocation of revenues we generated for fiscal years 2006, 2005, and 2004 between contracts awarded on a sole-source basis and contracts awarded on a competitive-bid basis.



	FY06	FY05	FY04
Sole-source contracts	70%	82%	96%
Competitive-bid contracts	30%	18%	4%
	-----	-----	-----
	100%	100%	100%
	=====	=====	=====

Sole-source and competitive-bid contracts can be fixed-price contracts, where we agree to deliver equipment for a fixed price and we assume the risk of cost overruns, or cost-reimbursement contracts, where we are reimbursed for our direct and indirect costs and paid a negotiated profit, or time-and-materials contracts, where we are reimbursed by a negotiated billing rate applied to the level-of-effort completed. Historically, we have achieved greater profit margins from our fixed-price contracts than from our cost-reimbursement and time-and-materials contracts. In recent years, our significant contracts have been cost-reimbursement contracts. The following table represents our revenue concentration during the respective periods by contract type.

	FY06	FY05	FY04
Cost-reimbursement contracts	79%	76%	71%
Fixed-price contracts	17%	21%	26%
Time-and-materials contracts	4%	3%	3%
	-----	-----	-----
	100%	100%	100%
	=====	=====	=====

Most of our fixed-price contracts are for the manufacture of multiple units of our established products, rather than the development of new products. We believe that the risk of cost overruns is much less in the case of fixed-price manufacturing contracts, where the product has already been developed and at least a prototype made, than in the case of fixed-price development contracts.

Four contracts represented an aggregate of 42.1% of revenues for fiscal year 2006. Four contracts represented an aggregate of 29.4% of revenues for fiscal year 2005, and three contracts represented an aggregate of 28.4% of revenues for fiscal years 2004. All of these contracts were cost-reimbursement contracts.

We are subject to price redetermination on certain fixed-price United States Government contracts if it is determined that we did not price our products and services consistent with the requirements of the Federal Acquisition Regulations. During fiscal years 2006, 2005, and 2004, we did not have claims against us for noncompliance with these regulations, although, during fiscal year 2005 we did settle one dispute with the United States Government relating to earlier contracts.

Almost all of our contracts contain termination clauses that permit contract termination by the customer for cause upon our default or without cause for the convenience of the other contracting party. In either case, terminations could adversely affect our operating results. Under contracts terminable at the convenience of the United States Government, a contractor is generally entitled to receive payments for its allowable costs and, in general, the proportionate share of fees or earnings for the work done. Contracts that are terminable for default generally provide that the United States Government only pay for the work it has accepted and may require the contractor to pay for the incremental cost of reprocurement and may hold the contractor liable for damages incurred by the customer.

## Marketing

Our primary marketing efforts consist of personal contact between our technical personnel and technical representatives of existing and potential customers. We involve all technically qualified staff members in our marketing program. We believe that it is extremely important to have technically knowledgeable staff make marketing contacts since an initial system concept is often developed during the first marketing contact.

In addition to our primary technical marketing, we also conduct marketing activities designed to increase our visibility with existing and potential customers. Each year we conduct equipment shows in the Washington, D.C. area, demonstrating the operation of many of our products, and participate in shows sponsored by professional organizations. Additionally, we use direct mail and magazine advertising from time to time to inform potential customers of available products. We also produce a product summary catalog.

## Backlog

Our backlog, which consists of anticipated revenues from the uncompleted portions of existing contracts and excludes unexercised options, was \$104,952,000, \$140,193,000, and \$143,369,000, at October 31, 2006, 2005, and 2004, respectively. Anticipated revenues included in backlog may be realized over a multi-year period and include expected revenues from contracts that are fully funded as well as from contracts that are only partially funded. We include expected revenues from a contract in backlog when the contract is signed by us and by our customer. We believe the backlog figures are firm, subject only to the cancellation and modification provisions contained in our contracts. (See “Item 7: Management’s Discussion and Analysis of Financial Condition and Results of Operations – New Orders and Backlog.”) Because of possible future changes in delivery schedules and cancellations of orders, backlog at any particular date is not necessarily representative of actual sales to be expected for any succeeding period, and actual sales for the year may not meet or exceed the backlog represented. We may experience significant contract cancellations that were previously booked and included in backlog.

## **Research and Development**

We conduct R&D pursuant to United States Government R&D contracts and as part of our own R&D investment. We believe that our investment in R&D provides us with a significant competitive advantage. Research and development expenses incurred by us were approximately \$19,165,000, \$16,125,000, and \$14,166,000 in fiscal years 2006, 2005, and 2004, respectively. As a percent of revenue, R&D equated to 11.8%, 10.3%, and 9.9% in fiscal years 2006, 2005, and 2004, respectively.

In fiscal years 2006, 2005, and 2004, our R&D program was funded entirely by the billing rates charged to our customers.

We seek to develop technology capable of addressing new global security signal processing requirements before our competitors. In addition, we focus R&D on developing products and services that can be used, with or without further modification, to satisfy various needs of a variety of customers, thereby permitting us to offer a prompt solution.

## **Company Technical Operations**

Our technical business operations consist of a Multichannel Systems Division, a Wireless Communication Systems Division, an Ocean Systems Division, a National Security Systems Division, an Electronic Systems Division, and an Operations Division. All of these organizations report to our Chief Operating Officer. Because of the integral technologies and operations of our divisions to date, as well as the joint product development and common customers for our divisions, we have determined that we have only one corporate-wide reporting entity.

The Multichannel Systems Division and Wireless Communications Systems Division provide our COMINT products and services, and research and development for COMINT collection and processing solutions.

The Ocean Systems Division and the National Security Systems Division provide advanced sensor signal processing solutions for space-based, airborne, terrestrial, and undersea sensor technologies.

The Electronic Systems Division provides research and development for solutions to ELINT requirements.

The Operations Division is primarily responsible for manufacturing multiple units of products for all our divisions.

As of December 8, 2006, we had 504 employees in technical operations. (See “Item 1: Business – Employees” on page 14.)

## **Competition**

The global security market is highly competitive and we expect that competition will continue to increase in the future. Some of our current and potential competitors have significantly greater technical, manufacturing, financial, and marketing resources than we do. Our current competitors include L-3 Communications, BAE Systems, Boeing, Raytheon Corporation, General Dynamics, Harris Corporation, Lockheed Martin, Northrop Grumman, Argon ST, Digital Receiver Technology, EDO Corporation, QinetiQ, and Sierra Nevada Corporation. Substantial competition could impose pricing pressure on sales of our products, develop and introduce new products meeting market demand more quickly than we can, and result in lower revenue and decreased sales, which would have a materially adverse effect on our financial condition and operating results.

The competition for competitive-bid contracts differs from the competition for sole-source contracts. Companies competing for competitive-bid contracts prepare bids and proposals in response to either commercial or government requests and typically compete on price. Potential suppliers compete informally for sole-source contracts through R&D investment and marketing efforts. Companies competing for sole-source contracts attempt to identify the customer’s requirements early and invest in solutions so that they can demonstrate a distinguishing expertise or technology promptly after the customer has identified a signal processing requirement. The principal factors of competition for sole-source contracts include investments in R&D; the ability to respond promptly to government needs; and product price relative to performance, quality, and customer support. We believe that we compete favorably on each of these factors.

## Proprietary Rights

The United States Government has rights to most of the technology that we have developed under government contracts, including rights to permit other companies, including our competitors, to use this technology to develop products for the United States Government. To our knowledge, the United States Government has not exercised these rights related to our products.

As of October 31, 2006, we had four issued patents. We believe that, given the rapidly changing nature of signal collection and processing technology, our future success will depend primarily upon the technical competence and creative skills of our personnel, rather than the legal protection afforded by patents. We attempt to protect our trade secrets and other proprietary information through agreements with customers, employees, and consultants, and through other security measures. To the extent we wish to assert our patent rights, we cannot be sure that any claims of our patents will be sufficiently broad to protect our technology. In addition, there can be no assurance that any patents issued to us will not be challenged, invalidated, or circumvented; that any rights granted under these patents will provide us adequate protection; or that there will be sufficient resources to protect and enforce our rights. In addition, the laws of some foreign countries may not protect our proprietary rights to the same extent as do the laws of the United States. Although we do not believe that we are infringing upon the intellectual property rights of others, it is possible that such a claim will be asserted against us in the future. In the event any third party makes a claim against us for infringement of patents or other intellectual property rights of a third party, such claims, with or without merit, could be time-consuming and result in costly litigation. In addition, we could experience loss or cancellation of customer orders, could experience product shipment delays, or could be subject to significant liabilities to third parties. If our products were found to infringe on a third party's proprietary rights, we could be required to enter into royalty or licensing agreements to continue selling our products. Royalty or licensing agreements, if required, may not be available under acceptable terms or at all, which could seriously harm our business. Our involvement in any patent dispute or other intellectual property dispute or action to protect trade secrets and expertise could have a materially adverse effect on our business.

## Government Regulations

We must comply with regulatory requirements of federal, state, and municipal authorities applicable to companies contracting with the United States Government and its agencies, including regulations concerning employment obligations and affirmative action, workplace safety, and protection of the environment. Most importantly, we must comply with detailed government procurement and contracting regulations and with United States Government security regulations, certain of which carry substantial penalties for noncompliance or misrepresentation in the course of negotiations. Failure to comply with our government procurement or contracting obligations or security obligations could result in penalties imposed on us or suspension from government contracting, which would prevent us from selling our products to the United States Government, severely limiting our ability to operate our business and generate revenue, resulting in a materially adverse effect on our financial condition and operating results. (See "Item 1: Business – Customers, Contracts, and Marketing" on page 10.)

While compliance with applicable regulations has not adversely affected our operations in the past, we cannot be sure that we will continue to be in compliance in the future or that these regulations will not change, resulting in increased operational costs.

## Employees

As of December 8, 2006, we had 647 employees. Our business requires that a large number of our technical employees obtain security clearances from the United States Government, which limits the available pool of eligible candidates for such positions to those who can satisfy the prerequisites to obtaining these clearances. In particular, the personnel involved in marketing require the appropriate clearances to meet with government technical representatives and discuss the government's needs. We have a United States Government-sanctioned security program that allows staff members to obtain appropriate clearances. Approximately 76% of our staff has security clearances. Our success is dependent on attracting, retaining, and motivating qualified key management and technical personnel, the loss of whom could adversely affect our business materially. We believe we maintain a good relationship with our employees.

## Item 1A: Risk Factors

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

***We may not be successful in our expansion of our products and markets, and may not realize the benefits of our investments in these new markets.*** We are subject to a number of special risks as a result of our acquisition of Dynamics Technology, Inc. (DTI). On July 1, 2005, we acquired DTI for approximately \$30.1 million, plus estimated transaction costs. As a result of this acquisition, together with investments we are making in other areas complementary to our historic COMINT offerings, we are expanding our products, approaching new customers, and entering into new markets for advanced digital signal processing products, systems, and services in support of intelligence, surveillance, and reconnaissance (ISR) for global security. Our operations during fiscal year 2006 were, and are expected to continue to be, substantially influenced by the operations of the businesses we acquired from DTI as well as from our continued investment in products and markets complementary to our existing and new businesses. This expansion subjects us to a number of risks and uncertainties, including:

- We are entering markets in which we have no or limited prior experience. We may not be successful in these markets, and we may be unable to enter into new contracts for these new business lines or grow the combined business. We may not achieve the strategic objectives and other anticipated potential benefits of the acquisition of DTI or the investment in other products. Our failure to achieve these strategic objectives could have a material, adverse effect on our revenues, expenses, and operating results.
- As a result of the acquisition of DTI, we incurred debt in the amount of \$10 million, of which \$8.2 million remains outstanding as of October 31, 2006, and our failure to repay this debt when due would materially, adversely affect our financial condition and results of operations.
- We may also be assuming unknown liabilities, risk the incurrence of expenses related to the future impairment of goodwill, or the incurrence of other large write-offs immediately or in the future.

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

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

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

Many of the personnel we hire will need United States Government security clearances in order to perform tasks required on our government contracts, and without such clearances, employees cannot work on the majority of our projects. We have found that there is a shortage of qualified personnel possessing the necessary clearances, and new security clearances are taking longer to be granted. If we are not able to obtain security clearances for our personnel where required, they will be unable to perform tasks requiring clearances, and we may be unable to satisfy the terms of our contracts, resulting in customer dissatisfaction and possible loss of current or future contracts.

***Stop-work orders could negatively impact our operating results and financial condition.*** Almost all of our contracts contain stop-work clauses that permit the Government or other contracting party, at any time, by written order, to stop work on all or any part of the work called for by the contract for a period of ninety days. Within the ninety-day period, the other contracting party may cancel the stop-work order and resume work or terminate all or part of the work covered by the stop-work order. There can be no assurance that stop-work orders will not be received in future periods. If we receive additional stop work orders, our orders and backlog may be reduced, and we may fail to achieve anticipated revenues.

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

In the event there are shifts in responsibilities and functions among the government agencies responsible for United States defense and intelligence, it could result in a reduction of orders for global security by the defense and intelligence agencies that have historically been our major customers. Our relationships with other Government agencies to which responsibilities and functions for our contracts have shifted may not be as strong as our relationships with current customer agencies. Accordingly, a reduction in contracts from our customer agencies may not be offset by contracts from other United States Government agencies. Even if other agencies increase spending for global security, we may not secure the same amount of work from these agencies. As a result, demand for our products and services could decline, resulting in a decrease in revenues, and could adversely affect our operating results and financial condition materially.

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

***We depend on revenues from a few significant contracts, and any loss, cancellation, reduction, or delay in these contracts could harm our business.*** From time to time, including recent periods, we have derived a material portion of our revenue from one or more individual contracts that could be terminated by the customer in full or in part at the customer's discretion. We have in the past experienced a significant reduction of, and stop work order on, one of our largest contracts. We expect that in future periods we may again enter into individual contracts with significant revenue concentrations. In addition, the majority of our contracts are with a limited number of government agencies. If our individually large contracts were terminated or substantially reduced, we could fail to achieve expected revenues and net income.

***United States Government contracts are generally not fully funded at inception and funding may be terminated or reduced at any time.*** We act as a prime contractor or subcontractor for many different United States Government programs. Department of Defense and intelligence contracts typically involve long lead times for design and development and are subject to significant changes in contract scheduling. Programs can be partially funded initially, and additional funds may or may not be allocated. The termination or reduction of funding for a government program would result in a loss of anticipated future revenues attributable to that program.

Our backlog as of October 31, 2006, was approximately \$105 million and includes orders under awards that in some cases extend several years. The actual receipt of revenues on awards included in backlog may never occur or may change because a program schedule could change or the program could be canceled, or a contract could be reduced, modified, or terminated early.

***Our business depends upon our relationships with, and the performance of, our prime contractors.*** We expect to continue to depend on relationships with other contractors for a substantial portion of our revenues in the foreseeable future. Our business, prospects, financial condition, or operating results could be adversely affected if other contractors terminate or reduce their subcontracts or relationships with us, either because they choose to establish relationships with our competitors or because they choose to directly offer services that compete with our business. Our business also suffers if the prime contractor fails to win the contract, or if the Government terminates or reduces these other contractors' programs or does not award them new or additional contracts.

In addition, on those contracts for which we are not the prime contractor, the United States Government could terminate a prime contract under which we are subcontractor, regardless of the quality of our performance as a subcontractor. A prime contractor's performance deficiencies could adversely affect our status as a subcontractor on the program, jeopardize our ability to collect award or incentive fees, cause customers to delay payments, and result in contract terminations.

***We depend on revenues from a few significant customers; the loss of any significant customer could have an adverse effect on our business.*** Our success will depend on our continued ability to develop and manage relationships with significant customers. The markets in which we sell our products are dominated by a relatively small number of governmental agencies and allies of the United States Government, thereby limiting the number of potential customers. Our dependence on large orders from a relatively small number of customers makes our relationship with each customer critical to our business. We cannot be sure that we will be able to retain our largest customers, that we will be able to attract additional customers, or that our customers will continue to buy our products and services in the same amounts as in prior years. The loss of one or more of our largest customers, any reduction or delay in sales to these customers, our inability to successfully develop relationships with additional customers, or future price concessions that we may have to make could significantly harm our business.

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

***Unexpected increases in the cost to develop or manufacture our products under fixed-price contracts may cause us to experience unreimbursed cost overruns resulting in reduced profit margins or increased loss provisions.*** A significant portion of our revenue is derived from fixed-price contracts. Under fixed-price contracts, unexpected increases in the cost to develop or manufacture a product, whether due to

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inaccurate estimates in the bidding process, unanticipated increases in materials costs, unfavorable indirect rate variances, inefficiencies, or other factors, are borne by us. We have experienced cost overruns in the past that have resulted in losses on certain contracts, and may experience additional cost overruns in the future. Such cost overruns would increase our operating expenses, reduce our net income and earnings per share, and could have a material, adverse effect on our future results of operations and financial condition.

Fixed price contracts use percentage-of-completion accounting to determine profit margins. Under generally accepted accounting principles unexpected cost over-runs can change the percentage completion estimates and result in reduced profit margins and the reversal of previously recognized profits in addition to reducing future period profits. Although we believe that our profit margins are fairly stated and that adequate provisions for losses for our fixed-price contracts are recorded in our financial statements as required under accounting principles generally accepted within the United States, there can be no assurance that our contract profit margins will not decrease or our loss provision will not increase in the future.

***Unexpected contract terminations could negatively impact our operating results and financial condition.*** Almost all of our contracts contain termination clauses that permit contract termination upon our default or for the convenience of the other contracting party. In either case, termination could adversely affect our operating results and financial condition; however, we received no such notifications in fiscal years 2006 or 2005.

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

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

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

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

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

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

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

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

***Delays in the receipt of contracts could negatively impact our business.*** During our history, the receipt of certain final contracts has periodically been delayed to periods later than originally expected. Delays in the receipt of such orders could result in revenues falling short of estimates. On some of these contracts, we will make expenditures in advance of receipt of the final contract in anticipation of meeting the expected timetables, and will from time to time hire personnel in anticipation of receipt of the contract. If the contract is delayed, these costs are not covered. In addition, gross margins and net income will decrease if we elect to hold our cost structure in place while awaiting the award of delayed contracts.

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

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

***Continued compliance with new regulatory and accounting requirements will be challenging and may cause our general and administrative expenses to increase and impact our future financial position and results of operations.*** As a result of compliance with the Sarbanes-Oxley Act of 2002, as well as changes to listing standards adopted by the Nasdaq Stock Market, and the attestation and accounting changes required by the SEC, we are required to implement additional internal controls, to improve our existing internal controls, and to comprehensively document and test our internal controls. Although we successfully met our compliance with internal control evaluation and attestation at the end of fiscal year 2006, we continue to remain subject to these requirements, and as a result, expect to continue to obtain outside legal, accounting, and advisory services, all of which may add to our general and administrative costs. In addition, changes in the accounting rules, including legislative and other requirements to account for employee stock options as a compensation expense among others, could materially increase the expenses that we report under generally accepted accounting principles, which may adversely affect our operating results.

***Changes in stock option accounting rules have adversely impacted our operating results prepared in accordance with generally accepted accounting principles.*** We have historically used broad-based employee stock option programs to hire, incentivize, and retain our workforce in a competitive marketplace. In December 2004, the FASB issued SFAS 123R, *Share-Based Payment*, which requires all companies to measure compensation cost for all share-based payments, including employee stock options, at fair value. These rules became applicable to us with the quarter ended January 28, 2006, and we have adopted Statement 123R beginning with the first quarter of our 2006 fiscal year, and implemented the new standard on a prospective basis. As a result of the adoption of SFAS 123R, we have incurred approximately \$4,283,000 in stock compensation expense. We expect to continue to incur compensation expense in the future. Please refer to “Notes to Consolidated Financial Statements, Note 1: Summary of Significant Accounting Policies, Stock-Based Compensation.”

***Any increased review of our financial disclosure, including any future restatement of earnings, could increase litigation risks and adversely impact our stock price.*** A number of recent financial reporting issues and practices have recently received enormous public scrutiny, including practices concerning the accounting for employee stock option grant practices. If we are required to restate our financial statements as a result of a determination that we had incorrectly applied generally accepted accounting principles, that restatement could adversely affect our historic results, and the trading price of our securities. The recent scrutiny regarding financial reporting may also result in an increase in litigation involving companies with publicly traded securities, such as us. There can be no assurance that any such litigation against us would not materially adversely affect our business or the trading price of our securities.

***We face litigation risks as a result of our stock option review and restatement of our financial statements.*** Our historical stock option practices and the restatement of our prior financial statements have exposed us to greater risks associated with litigation, including the risk that derivative actions could be filed against us or certain current and former directors and officers based on allegations relating to our historical stock option practices. Litigation may be time consuming, expensive and distracting for management from the conduct of our business. The adverse resolution of any lawsuit could have a material adverse effect on our business, financial condition and results of operations. We cannot assure that any future litigation relating to our historical stock option practices will result in the same conclusions reached by us. Furthermore, if we are subject to adverse findings in any of these matters, we could be required to pay damages or penalties or have other remedies imposed upon us which could adversely affect our business, results of operations, or financial condition.

We may in the future be subject to regulatory proceedings or actions arising in relation to our historical stock option practices and the restatement of our prior period financial statements. Any potential regulatory proceeding or action may be time consuming, expensive and distracting for management from the conduct of our business. The adverse resolution of any potential regulatory proceeding or action could adversely affect our business, results of operations, or financial condition. We cannot assure that any future regulatory action relating to our historical stock option practices, will result in the same conclusions reached by us. Furthermore, if we are subject to adverse findings in any of these matters, we could be required to pay damages or penalties or have other remedies imposed upon us, including criminal penalties, which could adversely affect our business, results of operations, or financial condition.

## **Item 1B: Unresolved Staff Comments**

None.

## **Item 2: Properties**

Our corporate offices, located in Sunnyvale, California, also serve as our primary research and development, engineering, production, marketing, and administrative center. As of October 31, 2006, we leased five buildings in Sunnyvale, California, totaling approximately 266,077 square feet under a lease that expires in March 2012.

In addition, we maintain ten additional offices within the United States. As of October 31, 2006, we lease the following properties: 61,038 square feet in Annapolis Junction, Maryland (lease expires April 2016); 15,250 square feet in Herndon, Virginia (lease expires March 2011); 10,962 square feet in Hillsboro, Oregon (lease expires October 2009); 27,345 square feet in Salt Lake City, Utah (lease expires October 2009); 32,000 square feet in Allen, Texas (lease expires February 2011); 19,383 square feet in Torrance, California (lease expires February 2008); 2,008 square feet in Torrance, California (lease expires October 2007); 4,328 square feet in Anaheim, California (lease expires April 2009); 14,090 square feet in Arlington, Virginia (lease expires June 2013); and 2,309 square feet in Tampa, Florida (lease expires April 2010).

Our business requires that we maintain a facility clearance, sponsored and approved by the United States Government, at most of our offices. This approval could be suspended or revoked if we are found not to have complied with security regulations applicable to such facilities. Any revocation or suspension of such approval that materially delayed delivery of our products to customers would have a material, adverse impact on our ability to manufacture and sell our products and operate our business. Although we have adopted policies directed at assuring our compliance with relevant regulations, there can be no assurance that the approved status of our facilities will continue without interruption.

## **Item 3: Legal Proceedings**



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We are subject to litigation, from time to time, in the ordinary course of business including, but not limited to, allegations of wrongful termination or discrimination or governmental agency investigations. As a government contractor, we may also be subject to investigations by the United States Government for alleged violations of procurement or other federal laws. Under present government procurement regulations, if judged in violation of procurement or other federal civil laws, we could be suspended or barred from eligibility for awards of new government contracts.

On March 11 and July 19, 2005, purported securities class action complaints were filed in the United States District Court, Northern District of California. The cases were considered as *In re Applied Signal Technology Inc. Securities Litigation*, Master File No. 4:05-cv-1027 (SBA). The amended consolidated complaint is brought on behalf of a putative class of persons who purchased our Company's securities during a class period of August 24, 2004, through February 22, 2005. The complaints name us, our Chief Executive Officer, and our Chief Financial Officer as defendants, and allege that false and misleading statements regarding us were issued during the class period. On February 8, 2006, the Court dismissed the case with prejudice and entered judgment in defendants' favor. Plaintiffs appealed the judgment of dismissal on March 23, 2006; any future unfavorable outcome of the litigation could have an adverse impact on our business, financial condition, and results of operation. At this time we cannot estimate the amount of possible loss or range of loss that might be incurred as a result of this proceeding.

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

There were no matters submitted to a vote of security holders during the fourth quarter of the fiscal year.

## Part II

### Item 5: Market for Registrant's Common Equity, Related Shareholder Matters, and Issuer Purchases of Equity Securities

#### Selected Common Stock Data

Our common stock trades on the NASDAQ National Market under the symbol "APSG." As of October 31, 2006, the closing price of our common stock, as reported on NASDAQ, was \$14.84, and we had approximately 403 registered shareholders of record with our transfer agent. The following table sets forth the high and low closing prices for our common stock over the eight quarters ending October 31, 2006.

Closing prices, as reported on NASDAQ	High	Low
<b>Fiscal year ended October 31, 2005</b>		
First quarter	\$38.89	\$27.42
Second quarter	\$30.35	\$19.51
Third quarter	\$21.75	\$16.50
Fourth quarter	\$21.25	\$17.16
<b>Fiscal year ended October 31, 2006</b>		
First quarter	\$23.50	\$16.80
Second quarter	\$24.02	\$17.95
Third quarter	\$18.69	\$14.43
Fourth quarter	\$15.70	\$14.23

The Company will continue the dividend at the rate of \$0.50 per share per annum, payable quarterly. Dividends are expected to be paid on February 16, 2007, May 18, 2007, August 17, 2007, and November 16, 2007, to shareholders of record at February 2, 2007, May 4, 2007, August 3, 2007, and October 31, 2007.

In November 2005, dividends were declared at the rate of \$0.50 per share per annum. These dividends were paid on February 10, 2006, May 12, 2006, August 11, 2006, and November 10, 2006, to shareholders of record at January 27, 2006, April 28, 2006, July 28, 2006, and October 31, 2006.

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The continued payment of dividends and the amount thereof in the future will depend on a number of factors, including our financial condition, capital requirements, results of operations, future business prospects, and other factors that our Board of Directors may deem relevant.

We did not repurchase any of our equity securities during the fourth quarter of fiscal year 2006 nor issue any securities that were not registered under the Securities Act of 1933.

### Equity Compensation Plan Information

The equity compensation plan information required to be provided in this Annual Report on Form 10-K is incorporated by reference to our proxy statement for the 2007 Annual Meeting of Shareholders to be filed with the Securities and Exchange Commission within 120 days after the end of the fiscal year ended October 31, 2006.

### Item 6: Selected Financial Data

The information presented in the following financial position table has been adjusted to reflect the restatement of our financial results, which is more fully described in the "Explanatory Note" immediately preceding Part I of this Form 10-K and in "Note 2: Restatement of Financial Statements" in "Notes to Consolidated Financial Statements." We have not amended our previously filed annual reports on Form 10-K for the periods affected by this restatement. The financial information that has been previously filed or otherwise reported for these periods is superseded by the information in this annual report, and the financial statements and related financial information contained in such previously filed reports should no longer be relied upon. Our historical results of operations are not necessarily indicative of results of operations to be expected for any future period.

See "Item 7: Management's Discussion and Analysis of Financial Condition and Results of Operations" and "Note 2: Restatement of Financial Statements" in "Notes to Consolidated Financial Statements" for more detailed information regarding the restatement of our balance sheet and statement of shareholders equity for the fiscal year ended October 31, 2005, related statements of operations, shareholders' equity, and cash flows for the year ended October 31, 2004, and the changes to the financial statements for the years ended October 31, 2000, October 31, 2001, October 31, 2002, October 31, 2003, and October 31, 2004.

The following table shows the accounting periods to which the stock compensation, payroll expense, and income tax adjustments relate.

Adjustments to Stock Based Compensation on Consolidated Statement of Operations	Cumulative Effect at October 31, 2004	Fiscal Year 2004	Cumulative Effect at October 31, 2003	Fiscal Year 2003	Fiscal Year 2002	Fiscal Year 2001	Fiscal Year 2000
Total adjustments to pre-tax net income (loss)	\$(1,654)						