APPLIED SIGNAL TECHNOLOGY INC
Form 10-Q
March 14, 2003

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

Form 10-Q

(Mark One)

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

For the Period Ended January 31, 2003

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 Avenue, Sunnyvale, CA 94086
(408) 749-1888
(Registrant s telephone number, including area code)

Not Applicable
(Former name, former address, and former fiscal year, if changed since last report)

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

ü

Yes No

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

ü

Yes No

Applicable Only to Corporate Issuers

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

Common Stock, no par value, 10,293,900 shares outstanding as of January 31, 2003.

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Applied Signal Technology, Inc.

Part I. Financial Information

Item 1: Financial Statements

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

Assets	January 31, 2003 (Unaudited)	October 31, 2002 (Note)
Current assets:		
Cash and cash equivalents	$10,174	$12,217
Short term investments	20,557	12,710
Accounts receivable:		
Billed	9,113	14,821
Unbilled	9,653	9,806
Total accounts receivable	18,766	24,627
Inventory	9,497	7,259
Prepaid and other current assets	1,928	2,083
Total current assets	60,922	58,896
Property and equipment, at cost:		
Machinery and equipment	42,870	41,921
Furniture and fixtures	4,956	4,956
Leasehold improvements	10,192	10,157
Construction in process	387	412
	58,405	57,446
Accumulated depreciation and amortization	(44,065)	(42,932)
Net property and equipment	14,340	14,514
Other assets	414	414
Total assets	$75,676	$73,824

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

Liabilities and Shareholders Equity	January 31, 2003 (Unaudited)	October 31, 2002 (Note)

Current liabilities:		
Accounts payable	$1,508	$1,496
Accrued payroll and related benefits	4,365	5,205
Other accrued liabilities	1,927	2,004
Income taxes payable	52	
Total current liabilities	7,852	8,705
Other liabilities	146	146
Shareholders equity:		
Common stock, no par value: 20,000,000 shares authorized; issued and outstanding: 10,293,900 at January 31, 2003 and 10,054,744 at October 31, 2002	27,455	26,565
Retained earnings	40,128	38,343
Accumulated comprehensive income	95	65
Total shareholders equity	67,678	64,973
Total liabilities and shareholders equity	$75,676	$73,824

Note: The balance sheet at October 31, 2002 has been derived from the audited financial statement at that date but does not include all of the information required by accounting principles generally accepted in the United States for complete financial statements.

See Notes to Consolidated Financial Statements.

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

	Three Months Ended	
	January 31, 2003	February 1, 2002
Revenues from contracts	$18,178	$16,231
Operating expenses:		
Contract costs	11,556	9,759
Research and development	1,701	1,917
General and administrative	2,921	2,700
Total operating expenses	16,178	14,376
Operating income	2,000	1,855

Interest income, net	100	24
Income before provision for income taxes	2,100	1,879
Provision for income taxes	315	188
Net income	$1,785	$1,691
Net income per common share:		
Basic	$0.17	$0.17
Diluted	$0.17	$0.17
Number of shares used in calculating net income per common share:		
Basic	10,216	9,732
Diluted	10,429	9,888

See Notes to Consolidated Financial Statements.

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

	Three Months Ended	
	January 31, 2003	February 1, 2002
Operating Activities:		
Net income	$1,785	$1,691
Adjustments to reconcile net income to net cash provided by (used in) operating activities		
Depreciation and amortization	1,173	1,286
Changes in:		
Accounts receivable	5,861	(2,248)
Inventory, prepaids, and other assets	(2,083)	(3,737)
Accounts payable, taxes payable, and accrued expenses	(853)	819
Net cash provided by (used in) operating activities	5,883	(2,189)
Investing Activities:		
Purchases of available-for-sale securities	(7,817)	
Additions to property and equipment	(999)	(108)

Net cash used in investing activities	(8,816)	(108)
Financing Activities:		
Issuance of common stock	890	680
Net cash provided by financing activities	890	680
Net decrease in cash and cash equivalents	(2,043)	(1,617)
Cash and cash equivalents, beginning of period	12,217	9,743
Cash and cash equivalents, end of period	10,174	8,126
Supplemental disclosures of cash flow information:		
Interest paid	$26	$13

See Notes to Consolidated Financial Statements.

Applied Signal Technology, Inc.
Notes to Consolidated Financial Statements
(unaudited)
January 31, 2003

Note 1: Summary of Significant Accounting Policies

Description of Business and Basis of Presentation

Applied Signal Technology, Inc. was incorporated in California on January 12, 1984. We provide advanced digital signal processing products, systems, and services used in reconnaissance of foreign telecommunications signals. Our primary customers are the United States Government and its foreign allies.

The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring adjustments) considered necessary for a fair presentation have been included. Operating results for the three-month period ending January 31, 2003 are not necessarily indicative of the results that may be expected for the year ending October 31, 2003. For further information, refer to the consolidated financial statements and footnotes thereto included in our Annual Report on Form 10-K for the year ended October 31, 2002.

Estimates

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

Revenues and Contract Accounting

Revenues and cost recognition. The majority of our contracts are accounted for in accordance with the American Institute of Certified Public Accountants Statement of Opinion 81-1, *Accounting for Performance of Construction-Type and Production-Type Contracts.*

We account for cost reimbursement contracts by charging contract costs to operations as incurred and recognizing contract revenues and profits by applying an estimated fee rate to actual costs on an individual contract basis. Cost-reimbursement contracts represent approximately 73% of contract revenues in the first quarter of fiscal year 2003 (61% in the first quarter of fiscal year 2002).

Our engineering services contracts are typically performed on a level-of-effort basis. Revenue is calculated in accordance with our policy regarding cost-reimbursement contracts; specifically, revenue is based on a fee percentage applied to the costs incurred on these contracts.

We account for fixed-price contracts by using the percentage-of-completion method of accounting. Under this method, contract costs are charged to operations as incurred. A portion of the contract revenue, based on estimated profits and the degree of completion of the contract as measured by a comparison of the actual and estimated costs, is recognized as revenue each period. Unexpected increases in the cost to develop or manufacture a product under a fixed-price contract, whether due to inaccurate estimates in the bidding process, unanticipated increases in material costs, inefficiencies, or other factors are borne by us, and could have a material adverse effect on our results of operations. Fixed-price contracts represent approximately 27% of contract revenues in the first quarter of fiscal year 2003 (39% in the first quarter of fiscal year 2002).

Management reviews contract performance, costs incurred, and estimated completion costs regularly, and adjusts revenues and profits on contracts in the period in which changes become determinable. Anticipated losses on contracts are recorded in the period in which they become determinable.

Indirect rate variance. We record contract revenues and costs for interim reporting purposes based on annual targeted indirect rates. At year-end, the revenues and costs are adjusted for actual indirect rates. During our interim reporting periods, variances may accumulate between the actual indirect rates and the annual targeted rates. All timing-related indirect spending variances are inventoried as part of work in process during these interim reporting periods. These rates are reviewed regularly, and we record reserves for any permanent variances in the period they become known. Please refer to "Notes to Consolidated Financial Statements, Note 2: Inventory" for the current year inventoried spending variance.

Our accounting policy is based on management s belief that such a variance will be absorbed by expected contract activities during the remainder of the year. If contract activities do not reach planned levels, there are alternatives we can utilize to absorb the variance: we can adjust downward some of our planned indirect spending during the year, increase our billing rates to our customers, or record charges to expense based on reduced estimates of future contract activities.

Award fees. Our policy for recognizing interim fees on our award fee contracts is based on management s assessment, on a contract-by-contract basis, as to the likelihood that the award fee or an incremental portion of the award fee will be earned. Management s assessments are based on numerous factors including: contract terms, nature of the work to be performed, our relationship and history with the customer, our history with similar types of projects, and our current and anticipated performance on the specific contract. No award fee is recognized until management determines that it is probable that an award fee or portion thereof will be earned.

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

Cash Equivalents and Investments

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

Short-term investments include securities that are classified as available-for-sale and are carried at fair market value. At the time of purchase, management determines the appropriate classification of these securities and re-evaluates such designation as of each balance sheet date. Unrealized gains and losses, net of tax, are reported in shareholders equity as part of retained earnings. The cost of securities sold is based on the specific identification method. Realized gains and losses on sales of available-for-sale securities were not material in the first three months of fiscal years 2003 and 2002.

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

	January 31, 2003			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Market Value
Cash and cash equivalents	$10,174	$	$	$10,174
Short-term, available-for-sale securities:				
Asset-backed securities	2,525	10		2,535
Corporate securities	5,318	26	(3)	5,341
Government securities	10,139	62		10,201
Money market securities	2,480			2,480
	$30,636	$98	($3)	$30,731
	========	========	========	========

	October 31, 2002			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Market Value
Cash and cash equivalents	$12,215	$2	$	$12,217
Short-term, available-for-sale securities:				
Asset-backed securities	1,523	5		1,528
Corporate securities	4,007	15	(2)	4,020
Government securities	7,117	45		7,162
	$24,862	$67	($2)	$24,927
	========	========	========	========

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

	January 31, 2003	October 31, 2002

Due in one year or less	$6,036	$1,031
Due in one to three years	14,521	11,679
	$20,557	$12,710

Per Share Data

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

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

	Three Months Ended	
	January 31, 2003	February 1, 2002
Numerator:		
Net income	$1,785	$1,691
Denominator:		
Shares used to compute net income per common share-basic	10,216	9,732
Effect of dilutive stock options	213	156
Shares used to compute net income per common share-diluted	10,429	9,888
Net income per common share basic	$0.17	$0.17
Net income per common share diluted	$0.17	$0.17

Comprehensive Income

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

	Three Months Ended	
	January 31, 2003	February 1, 2002
Net income	$1,785	$1,691
Unrealized gain on securities	30	
Comprehensive income	$1,815	$1,691

As of January 31, 2003, net unrealized gain on securities was approximately $95,000. As of October 31, 2002, net unrealized gain on securities was approximately $65,000.

Note 2: Inventory

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

	January 31, 2003	October 31, 2002
Raw materials	$811	$812
Work in process	8,007	5,747
Finished goods	573	613
	________	________
	9,391	7,172
Precontract costs	106	87
	________	________
	$9,497	$7,259
	========	========

At January 31, 2003, the unfavorable inventoried indirect rate variance was approximately $1,004,000. At February 1, 2002, the unfavorable inventoried indirect rate variance was approximately $3,508,000. At October 31, 2002 and October 31, 2001, costs were recorded at actual indirect rates, and therefore the rate variance balances were zero. Management believes that the rate variance at January 31, 2003 will be absorbed by expected contract activities during the remainder of fiscal year 2003. For further information on our accounting policy for this inventoried variance, see "Notes to Consolidated Financial Statements, Note 1: Summary of Significant Accounting Policies."

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

Note 3: Recent Accounting Pronouncements

In August 2001, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, which addresses financial accounting and reporting for the impairment or disposal of long-lived assets and supersedes SFAS No. 121, *Accounting for the Impairment of Long-lived Assets and for Long-lived Assets to be Disposed Of*, and the accounting and reporting provisions of APB Opinion No. 30, *Reporting the Results of Operations*, for a disposal of a segment of a business. SFAS 144 is effective for fiscal years beginning after December 15, 2001, with earlier application encouraged. We adopted SFAS 144 on October 1, 2002 and the adoption did not have a material effect on our financial position or results of operations.

In July 2002, the FASB issued SFAS No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*. SFAS 146 addresses the financial accounting and reporting for obligations associated with an exit activity, including restructuring, or with a disposal of long-lived assets. Exit activities include, but are not limited to, eliminating or reducing product lines, terminating employees and contracts and relocating plant facilities or personnel. SFAS 146 specifies that a company will record a liability for a cost associated with an exit or disposal activity only when that liability is incurred and can be measured at fair value. Therefore, commitment to an exit plan or a plan of disposal expresses only management s intended future actions and does not meet the requirement for recognizing a liability and the related expense. SFAS 146 is effective prospectively for exit or disposal activities initiated after December 31, 2002, with earlier adoption encouraged. The adoption of SFAS 146 did not have an effect on our financial position or results of operations.

In December 2002, the FASB issued SFAS No. 148, *Accounting for Stock-Based Compensation Transition and Disclosure.* SFAS 148 amends SFAS 123, *Accounting for Stock-Based Compensation*, to provide alternative methods of transition to SFAS 123 s fair value method of accounting for stock-based employee compensation. SFAS 148 also amends the disclosure provisions of SFAS 123 and APB Opinion No. 28, *Interim Financial Reporting*, to require disclosure in the summary of significant accounting policies of the effects of an entity s accounting policy with respect to stock-based employee compensation on reported net income and earnings per share in annual and interim financial statements. SFAS 148 s amendment of the transition and annual disclosure requirements of SFAS 123 are effective for our fiscal year 2003. SFAS 148 s amendment of the disclosure requirements of Opinion 28 is effective for our second quarter of fiscal year 2003.

In November 2002, the FASB issued FASB Interpretation No. 45, *Guarantor s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*, an Interpretation of FASB Statements No. 5, 57, and 107 and Rescission of FASB Interpretation No. 34. The Interpretation elaborates on the disclosures to be made by a guarantor in its interim and annual financial statements about its obligations under certain guarantees that it has issued. It also requires a guarantor to recognize, at the inception of a guarantee, a liability for the fair value of the obligation undertaken in issuing the guarantee. The initial recognition and measurement provisions of the Interpretation apply to guarantees issued or modified after December 31, 2002. Applied Signal Technology does not expect the adoption of this accounting pronouncement to have a material effect on its consolidated financial position or results of operations.

Note 4: Line of Credit

At January 31, 2003, we had a $3,000,000 secured, revolving bank line of credit available for short-term cash requirements, which is secured by all of our assets and expires on March 15, 2003. Borrowings under the line of credit bear interest at the bank s reference rate (4.25% at January 31, 2003) and are payable monthly**.** At both January 31, 2003 and October 31, 2002, this facility was unused. Under this credit facility, we are subject to certain commitment and utilization fees on the unused portion of the committed amount. Fees incurred were not material during the first quarter of fiscal year 2003 and fiscal year 2002. The line of credit agreement requires us to comply with certain financial covenants. At both January 31, 2003 and October 31, 2002, we were in compliance with all restrictions and covenants, and this facility had not been utilized. We do not plan to renew this line of credit and have canceled the outstanding letters of credit associated with this facility. In February 2003 we entered into a new cash-secured line of credit in the amount $1,500,000, which will expire on March 1, 2004. Any borrowings bear interest at the bank s reference rate and accrued interest is payable monthly. There are no fees associated with the unused portion of the committed amount. Under this new line of credit agreement, we have one standby letter of credit outstanding in the amount of approximately $1,218,000, related to our facilities lease.

Note 5: Segment Reporting

The financial information relating to Applied Signal Technology is reviewed and evaluated by the chief operating decision-maker as a whole, and not its individual divisions. In addition, divisional financial information is not available below the gross margin level. Thus, there is only one reportable segment during the first three months of fiscal years 2003 and 2002.

Note 6: Provision for Income Taxes

Our estimated annual effective tax rate for the quarter ended January 31, 2003 was 15% compared to a 10% effective rate for the comparable period in 2002. Our projected annual effective tax rate for fiscal year 2003 is calculated based on the projected income for the year and differs from the statutory rate primarily due to a benefit of deferred tax assets for which a valuation allowance has been recorded at the end of fiscal year 2002.

Note 7: Contingencies

Product Warranties

Our products, including associated firmware and software, are warranted against defective workmanship and materials for a period of one year from the date of acceptance by the original purchaser. In addition, we offer extended warranties as a percentage of the purchase price. An additional six-month warranty may be purchased for 3% of the unit or system purchase price. Additional one-year warranty coverage is 5% of the unit or system purchase price. Warranty costs were approximately $43,000 and $83,000 for the first quarters of fiscal years 2003 and 2002, respectively.

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

The following information should be read in conjunction with the attached financial statements and notes thereto.

This quarterly report on Form 10-Q contains forward-looking statements made pursuant to the provisions of Section 21E of the Securities Exchange Act of 1934. These forward-looking statements are based on management s current expectations and beliefs, including estimates and projections about our industry. Forward-looking statements may be identified by the use of terms such as "anticipates," "expects," "intends," "plans," "seeks," "estimates," "believes," and similar expressions, although some forward-looking statements are expressed differently. Statements concerning financial position, business strategy, and plans or objectives for future operations are forward-looking statements. These statements are not guarantees of future performance and are subject to certain risks, uncertainties, and assumptions that are difficult to predict and may cause actual results to differ materially from management s current expectations. Such risks and uncertainties include those set forth herein under "Summary of Business Considerations and Certain Factors that May Affect Future Operating Results and/or Stock Price." The forward-looking statements in this report speak only as of the time they are made and do not necessarily reflect management s outlook at any other point in time. We undertake no obligation to update publicly any forward-looking statements, whether as a result of new information, future events, or for any other reason. However, readers should carefully review the risk factors set forth in other reports or documents we file from time to time with the Securities and Exchange Commission (SEC). Our SEC filings, as well as our latest annual report, can be obtained through our web site. In addition, hard copies can be obtained free of charge through our investor relations department.

Description of the Business

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

We were incorporated in California in 1984. Our principal executive offices are located at 400 West California Ave., Sunnyvale, CA, 94086, and our telephone number is (408) 749-1888. Our web site address is www.appsig.com. Our SEC filings, as well as our latest annual report, can be obtained through our web site. In addition, hard copies can be obtained free of charge through our investor relations department.

Signal Intelligence

Accurate and comprehensive information regarding foreign affairs and developments has become increasingly important to the United States Government. The reduction of United States military tactical forces overseas; the political instability in certain regions such as the Middle East, Eastern Europe, Africa, and Central and South America; and the continued efforts against terrorism have significantly 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 use of established telecommunications technologies has been supplemented, rather than replaced, by new telecommunications technologies that have been developed and commercialized. This trend has led to a significant increase in the overall volume of information communicated and an increase in the density of signals transmitted throughout the RF spectrum. This increase can be seen in the proliferation of facsimile, cellular, and digital signal telecommunications equipment and in the global information network (for example, the Internet) in recent years, resulting in a significant increase in the amount of information being communicated. Consequently, the requirement to develop signal reconnaissance equipment capable of collecting and processing an increased volume of signals, as well as new types of signals, has increased significantly.

We devote significant resources toward understanding the United States Government s signal reconnaissance 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 future needs of the United States Government. We believe that we invest a greater percentage of our revenues in R&D than is typical among our competitors. (See "Research and Develop