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

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

Form 10-Q

(Mark One)

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

For the Period Ended July 30, 2004

or

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

Commission file number 0-21236

Applied Signal Technology, Inc.

(Exact name of registrant as specified in its charter)

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

400 West California Avenue, Sunnyvale, CA 94086
(408) 749-1888

(Registrant s telephone number, including area code)
Not Applicable

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

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

ü

Yes No

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

ü

Yes No

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

Common Stock, no par value, 11,188,408 shares outstanding as of July 30, 2004.

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Applied Signal Technology, Inc.

Part I. Financial Information

Item 1: Condensed Financial Statements

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

Assets	July 30, 2004 (Unaudited)	October 31, 2003 (Note)
Current assets:		
Cash and cash equivalents	$25,585	$5,372
Short term investments	19,743	34,747
Total cash and cash equivalents and short term investments	45,328	40,119
Accounts receivable:		
Billed	18,795	16,335
Unbilled	17,160	10,227
Total accounts receivable	35,955	26,562
Inventory	6,209	6,875
Prepaid and other current assets	3,532	3,545
Total current assets	91,024	77,101
Property and equipment, at cost:		
Machinery and equipment	46,537	44,127
Furniture and fixtures	4,845	4,742
Leasehold improvements	10,259	10,236
Construction in process	163	33
	61,804	59,138
Accumulated depreciation and amortization	(49,803)	(46,897)
Net property and equipment	12,001	12,241
Other assets	2,000	605
Total assets	$105,025	$89,947

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

Liabilities and Shareholders Equity	July 30, 2004 (Unaudited)	October 31, 2003 (Note)

Current liabilities:		
Accounts payable	$3,034	$3,022
Accrued payroll and related benefits	9,191	7,557
Accrued rent	1,166	1,190
Other accrued liabilities	2,380	1,643
Income taxes payable	1,052	134
Total current liabilities	16,823	13,546
Other liabilities	300	183
Shareholders equity:		
Common stock, no par value: 20,000,000 shares authorized; issued and outstanding: 11,188,408 at July 30, 2004 and 10,767,145 at October 31, 2003	37,497	31,132
Retained earnings	50,427	45,021
Accumulated comprehensive income (loss)	(22)	65
Total shareholders equity	87,902	76,218
Total liabilities and shareholders equity	$105,025	$89,947

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

See Notes to Condensed Financial Statements.

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

	Three Months Ended		Nine Months Ended	
	July 30, 2004	August 1, 2003	July 30, 2004	August 1, 2003

Revenues from contracts	$38,275	$26,002	$103,380	$66,261
Operating expenses:				
Contract costs	24,629	17,538	67,075	42,950
Research and development	4,413	2,281	9,969	5,882
General and administrative	3,631	4,268	12,846	10,994
Total operating expenses	32,673	24,087	89,890	59,826
Operating income	5,602	1,915	13,490	6,435
Interest income, net	121	120	399	320
Income before provision for income taxes	5,723	2,035	13,889	6,755
Provision for income taxes	2,264	305	4,337	1,013
Net income	$3,459	$1,730	$9,552	$5,742
Net income per common share:				
Basic	$0.31	$0.16	$0.87	$0.55
Diluted	$0.29	$0.16	$0.83	$0.54
Number of shares used in calculating net income per common share:				
Basic	11,120	10,579	10,988	10,367
Diluted	11,734	11,049	11,578	10,703

See Notes to Condensed Financial Statements.

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

Nine Months Ended	July 30, 2004	August 1, 2003
Operating Activities:		
Net income	$9,552	$5,742
Adjustments to reconcile net income to net cash provided by operating activities	3,234	3,511

Depreciation and amortization		
Changes in:		
Tax benefit from stock plans	1,309	
Accounts receivable	(9,393)	(1,460)
Inventory, prepaids, and other assets	(716)	(936)
Accounts payable, taxes payable, and accrued expenses	2,668	1,727
Net cash provided by operating activities	6,654	8,584
Investing Activities:		
Purchases of available-for-sale securities	(27,169)	(21,700)
Maturities of available-for-sale securities	42,086	5,834
Additions to property and equipment	(2,994)	(1,778)
Net cash provided by (used in) investing activities	11,923	(17,644)
Financing Activities:		
Issuance of common stock	5,056	3,405
Dividends paid	(3,420)	(646)
Net cash provided by financing activities	1,636	2,759
Net increase (decrease) in cash and cash equivalents	20,213	(6,301)
Cash and cash equivalents, beginning of period	5,372	11,715
Cash and cash equivalents, end of period	$25,585	$5,414
Supplemental disclosures of cash flow information:		
Interest paid	$107	$91
Income taxes paid	$2,860	$1,905

See Notes to Condensed Financial Statements.

Applied Signal Technology, Inc.
Notes to Condensed Financial Statements
(Unaudited)
July 30, 2004

Note 1: Summary of Significant Accounting Policies

Description of Business and Basis of Presentation

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

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

Estimates

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

Revenues and Contract Accounting

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

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

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

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

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

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

The following table represents the revenue concentration by contract type:

	Three Months Ended		Nine Months Ended	
	July 30, 2004	August 1, 2003	July 30, 2004	August 1, 2003
Cost-reimbursement contracts	79%	72%	77%	74%
Fixed-price contracts	21%	28%	23%	26%

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

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

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

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

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

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

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

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

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

Price Redetermination

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

Cash Equivalents and Investments

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

Short-term investments include all securities that are classified as available-for-sale and are carried at fair market value. At the time of purchase, management determines the appropriate classification of these securities and re-evaluates such designation as of each balance sheet date. Unrealized gains and losses, net of tax, are reported in shareholders equity. 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 nine months of fiscal years 2004 and 2003.

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

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

	July 30, 2004			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Market Value
Cash and cash equivalents	$25,584	$1	$	$25,585
Short-term, available-for-sale securities:				
Asset-backed securities	5,505		(14)	5,491
Corporate securities	4,174	1	(4)	4,171
Government securities	6,008		(5)	6,003
Money market securities	4,079		(1)	4,078
	$45,350	$2	($24)	$45,328

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

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

	July 30, 2004	October 31, 2003
Due in one year or less	$19,511	$18,100
Due in one to three years	232	16,647
	$19,743	$34,747

Per Share Data

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

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

	Three Months Ended		Nine Months Ended	
	July 30, 2004	August 1, 2003	July 30, 2004	August 1, 2003
Numerator:				
Net income	$3,459	$1,730	$ 9,552	$ 5,742
Denominator:				
Shares used to compute net income per common share – basic	11,120	10,579	10,988	10,367
Effect of dilutive stock options	614	470	590	336
Shares used to compute net income per common share – diluted	11,734	11,049	11,578	10,703
Net income per common share – basic	$ 0.31	$ 0.16	$ 0.87	$ 0.55
Net income per common share – diluted	$ 0.29	$ 0.16	$ 0.83	$ 0.54

We excluded approximately 4,000 antidilutive potential common shares from diluted net income per common share computation for the third quarter and first nine months of fiscal year 2004, respectively. For the same periods in fiscal year 2003, we excluded approximately 50,000 and 190,000 antidilutive potential common shares from diluted net income per common share computation.

Comprehensive Income

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

	Three Months Ended		Nine Months Ended	
	July 30, 2004	August 1, 2003	July 30, 2004	August 1, 2003
Net income	$3,459	$1,730	$9,552	$5,742
Unrealized gain (loss) on securities	(16)	(83)	(87)	(23)
Comprehensive income	$3,443	$1,647	$9,465	$5,719

As of July 30, 2004, net unrealized loss on securities was approximately $22,000. As of October 31, 2003, net unrealized gain on securities was approximately $65,000.

Dividends

During fiscal year 2004, we have an annual dividend of $0.50 per share, payable over four quarters at the rate of $0.125 per share per quarter. Dividends were paid on February 13, 2004, May 14, 2004, and August 13, 2004 and are payable on November 12, 2004 for shareholders of record at January 30, 2004, April 30, 2004, July 30, 2004, and

October 31, 2004, respectively, and on such future dates that the Board of Directors may determine.

We paid dividends of approximately $3,420,000 and $646,000 during the first nine months of fiscal years 2004 and 2003, respectively.

At July 30, 2004 and October 31, 2003, accrued dividends of approximately $1,399,000 and $673,000, respectively, were included in other accrued liabilities in the accompanying balance sheet.

Stock-Based Compensation

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

		Three Months Ended		Nine Months Ended	
		July 30, 2004	August 1, 2003	July 30, 2004	August 1, 2003
Net income, as reported		$3,459	$1,730	$9,552	$5,742
Deduct: total stock-based compensation expense determined at the fair value for all awards		(1,825)	(825)	(2,914)	(1,645)
Pro forma net income		$ 1,634	$ 905	$ 6,638	$ 4,097
Net income per share					
Basic	As reported	$0.31	$0.16	$0.87	$0.55
	Pro forma	$0.15	$0.09	$0.60	$ 0.40
Diluted	As reported	$0.29	$0.16	$0.83	$0.54
	Pro forma	$0.14	$0.08	$0.57	$0.38

Note 2: Inventory

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

	July 30, 2004	October 31, 2003
Raw materials	$740	$775
Work in process	5,242	5,603
Finished goods	227	494
	6,209	6,872
Precontract costs		3
	$6,209	$6,875

At July 30, 2004, the favorable inventoried indirect rate variance reduced work in process by approximately $1,034,000. At August 1, 2003, the favorable inventoried indirect rate variance reduced work in process by approximately $1,185,000. Management determined that a portion of the favorable indirect rate variance at August 1, 2003 would remain unabsorbed by the end of fiscal year 2003, resulting in higher operating income. Consequently, at the end of the third quarter of fiscal year 2003, a $350,000 adjustment was recorded to increase operating income and reduce the favorable inventoried rate variance to approximately $835,000. For further information on our accounting policy for this inventoried variance, see "Notes to Condensed Financial Statements, Note 1: Summary of Significant Accounting Policies."

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

We provide advanced digital signal processing products and systems to the U.S. government. Typical life cycles of our equipment are eight to ten years or more. In addition, we maintain spare parts in order to repair the equipment. We evaluate our inventory quarterly at interim reporting periods, and assess our ability to sell our equipment, which includes raw materials. Historically, we have sold our inventory at full cost so there is limited decrement in